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BUSINESS REVIEW**

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The ROMANIAN ECONOMIC AND BUSINESS REVIEW (REBE) is a refereed journal published four times annually by the Romanian-American University. The editors invite submissions of articles that deal with important issues in economy and business. Papers that focus on specific phenomena and events affecting Romanian economy are particularly encouraged. Because REBE seeks a broad audience, papers should be comprehensible beyond narrow disciplinary bounds.

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## INDICATIVE PLANNING AND PLAN ECONOMIC DEVELOPMENT OF INDIA: A CO-INTEGRATION ANALYSIS

Hemanta Saikia\*

### Abstract

*The function of planning in a predominantly market-driven economy has to be symptomatic, co-coordinative and authoritarian. That provides the good reason for India's Planning Commission to engage in preparing development plans for the economy periodically even after liberalisation. However as it can't control investment in the private sector so such planning can at best be at least indicative. So the five year plans are now seek to provide an indicative path of development by setting out the imperatives for alternative growth scenarios in terms of macro-variables. It is still be necessary for planning commission to integrate and coordinate the plans of different ministries and undertakings of the central government, and bring them in line with the medium and long-term goals while keeping within the budget constraint. At the same time, the system of transfers from the centre needs to be reformed. There should be some rethinking on the relative roles of the planning commission and the finance commission. In this paper an attempt has been made to analyze the inter relation between economic development and directive roles of planning process in India.*

**Keywords:** Economic development, liberalization, indicative planning and Planning Policy

**JEL Classification:** O16, F15, B 20, O21

### Introduction

Development planning have played a pivotal role in successful upliftment of millions people out of poverty especially in South Asian countries including India. In exception, in many transitional countries, planned development process sometimes hinders development standards which may be due to violation of the basic rules of the development process and may be over emphasis on planning apparatus. However, in case of contemporary era, the main problem is to balance market economy with the public policy. Even though this problem may not crop up in the early stage of the development but with the expanding market frontiers and the pace towards extreme capitalism, the imbalance in between two sides are seemed to be acute and sometimes question the authenticity of the planning process. In this regard, after gaining independence from British colonial rule, South Asian embraced

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a development strategy whose key components formed the substance of development planning process. However, these countries have changed their development process from inward looking policy to an outward one, especially following the process of liberalization and other components of globalization. This is one hand expands their frontiers of development, on the other hand shift gears of expansion. But the end result is a contradiction between governmental rules, directions and ideology with the market based waves of procedures (Bagchi. 2007. P.45). So in modern form of capitalism and international atmosphere of trade and investment, the planning process needs to be integrated with the market rules as unless they are reformed and recapitalized with the development rules, the planning process may not be able provide optimum result. In this paper an attempt has been made to analyze the inter relation between economic development and directive roles of planning process in India especially pre and post liberalization periods. We seek to enquire in to the relationship between Governmental plan expenditure and national income in India for the periods of 1950-1951 to 1993-1994 through Co-Integration analysis.

### **Objective of the Paper:**

The main objectives of the paper are to

1. To examine the role of planning in different economic structure with special reference to India.
2. To analyse the interrelationship in between the plan expenditure and national income of India.
3. To discuss various 'outcome' or 'attainment' indicators of Indian plan economic development in India.

### **Hypothesis of the Paper:**

The main hypotheses of the paper are:

1. There is no interrelation in between the plan contribution and national income expansion from the time period of initiation of planning process in India.

### **Methodology:**

This paper is based on mainly based on secondary data which are used to study the macroeconomic study purpose. Secondary data is collected from the publications of various organizations viz. Planning Commission of India, EPW research Foundation, CSO, NSSO, etc. Data thus collected is processed and tabulated and then analyzed using statistical and econometrics tools. The co-integration analysis is used to determine the relative interrelationship between planning and economic development. ADF test is used to determine the stationarity of the variables.

## Planning Process and Economic System

Economic planning is a cognizant design of development for any nation. This is because different countries have different political as well as economic systems. In the socialist countries the role of the Govt in economic planning is very inclusive and undeviating. “The issue is not whether planning is needed, it surely is but whether the most effective place to do the planning is in a government centralized bureau or at the level of the firm. (Joseph E Stiglitz, 1997) In contrast in a industrially developed capitalist countries of the role of the planning are limited which is so called indicative planning. Between the above two groups of extreme cases we have the vast majority of the third world developing countries of Asia, Africa and Latin America, which have adopted the course of planned economic development in the post-war years with own national state and government. But in all structures, the state plays an active and directives role in planning the development of the national economy. Economic development in these countries is, therefore, planned as well as induced and directed by the market forces (Madhav. 2001. P.78). On the one hand, economic planning to be meaningful cannot be merely of an indicative type nor can it be, in the absence of monopoly control over means of production, of an imperative type. It is to be judicious mix of the two. The state has to adopt a proper mixture of direct and indirect controls.

### Development Planning in India

The outline of pre-1950 India can be summarized India’s status as a land of riches in the history of its deficiency. The mixed reputation has changed in recent centuries, and India is seen these days primarily as a land of poverty, famines, diseases, immorality, caste, untouchability, autonomy and pandemonium. The sixty years of sovereignty brought India a good deal of repute worldwide (Gupta. 1983. P. 246) . However reputation was offset by tragic images of human mortification, poverty and miseries until the beginning of the new millennium and in this parlance balanced regional development is a necessary step towards securing economic justice which is one of the fundamental views of the Indian constitution. Further, the 42<sup>nd</sup> Amendment of the Indian constitution, made an explicit direction towards a socialist state in India which bolstered the need for balanced regional development. Thus one finds balanced regional development to be a recurring theme in the designing of India’s economic policy and planning. At the same time, India's effort to gather speed of industrialization & improve international competitiveness received a boost up with the declaration of the New Industrial Policy in July 1991. Following liberalization, the role of the public sector in the Indian economy has somewhat minimized and is dwindling more and public-private partnership is now emerging as the preferred medium for initiatives in development. Given this background there is urgent need to think for the role for planning in India.

For a country like India where resources are limited, allocation of the resources

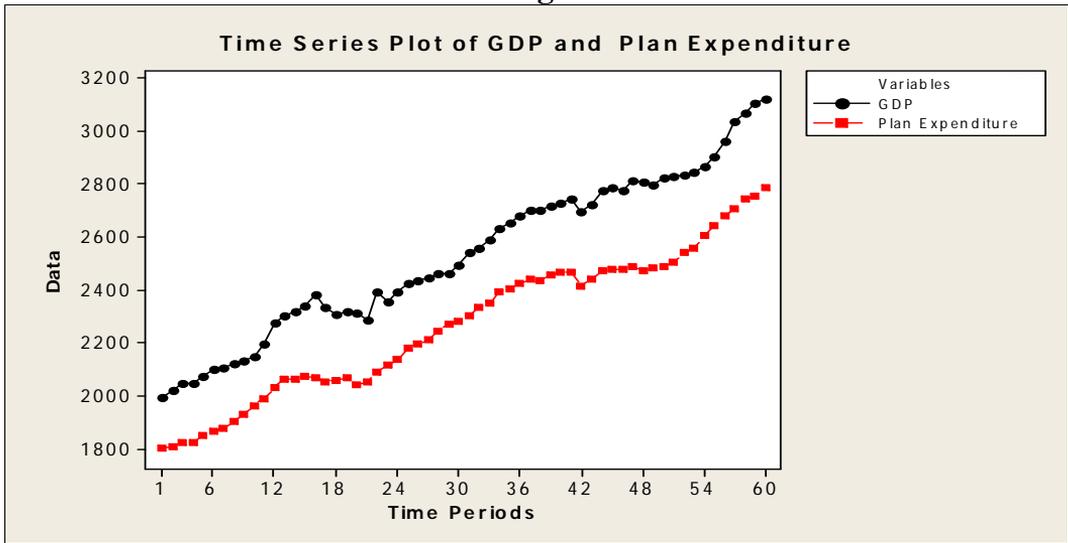
must be guided by an elegant indicative plan and the state can to play a vital role not only as a facilitator but also as a provider of basic infrastructure and collective physical resources. Thus, planning can be accommodating in a market economy by providing “indication, coordination and recommendation”. However the planning in a largely market-driven economy cannot proceed on the same footing as in an economy that is heavily controlled by the state. In the Indian context, this implies that there has to be a clear swing in the focus of planning now as compared to the past. As noted at the outset planners in India are amply aware of the need for such a change. The economic crisis of 1990, however, has altered India’s approach to economic policy. With resource allocation left to the market, anxieties were raised that the growth pattern in the post-reform phase would be skewed in favour of the already better-off states. However control over investment in the private sector beyond the purview of the planning commission, development planning can at best be indicative which was recognized after globalization even the Eighth Plan too. That planning now has to be mostly indicative and the state can at best be a provider for private enterprise was reiterated in the three plans that followed the Ninth, Tenth and Eleventh. At the same time, the foundations that helped in implementation of the plans during the controlled economy era also remain almost intact despite their well known shortcomings and irrelevance in the changed economic surroundings. Given this background, there is need a justification and modification review for planning process in India as there are several short comings of planning process of India in the present circumstances. Indian planning focused on three particular features of the planning methodology and the planning process. These are one, the lack of sophisticated plan models to ensure inter-sectoral consistency among production targets set by the plan. Even for an indicative plan, some idea is needed of the projections of key macro-variables in the varied time perspectives. Thus a major function of the planning commission must therefore be to prepare a macro-perspective plans which would indicate the growth and major characteristics of the economy with a longer perspective of plans (Kuznets. 1990. P. 315).

### **Stationarity Test of Indian National Income and Plan Expenditure in India:**

In this paper the time series data of Gross Domestic product (GDP) at market price and the govt yearly plan expenditure (adjusted with index number of 1993-1994) are used. Two specified variables are  $X_t$  and  $Y_t$ ; where  $X_t$  is the log real GDP at market price in 1993-1994 prices and  $Y_t$  is the log value of the govt yearly plan expenditure in 1993-1994 prices.

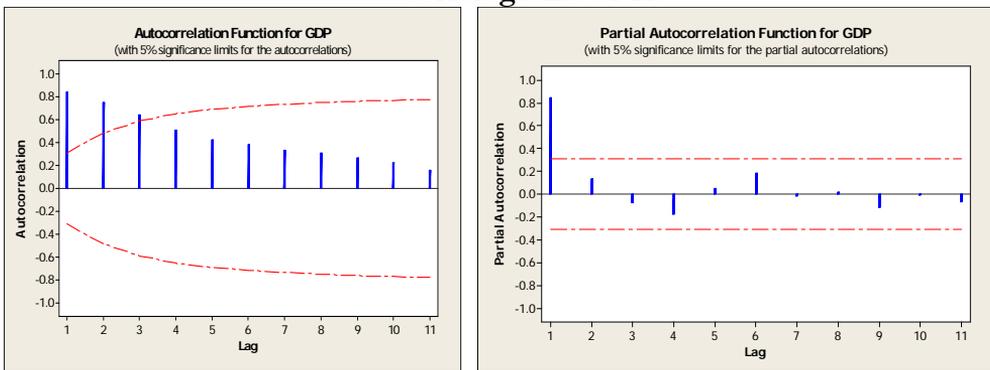
The time plot of the  $X_t$  and  $Y_t$  over periods concerned has been presented through the figure 1

Figure: 1



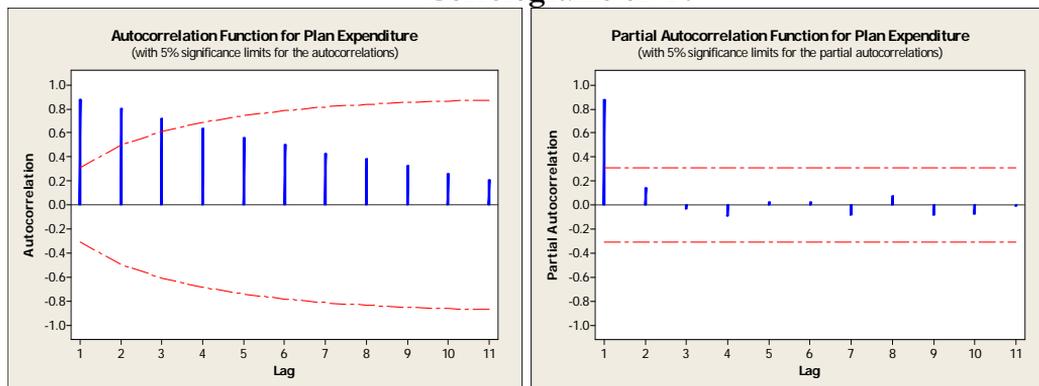
It is observed from the *figure: 1* that both the series exhibits stochastic trends over the periods concerned. These features of the series are pointer of their nonstationarity of  $X_t$  and  $Y_t$  which is also reflected by the their respective correlograms *fig:2*

Figure: 2  
Correlograms of  $X_t$



The correlograms of  $X_t$  reflects that ACF exhibits dying out patterns of spikes and the PACFs contains only one significant spikes which reflects the nonstationarity patterns of the stochastic process.

**Figure: 3**  
**Correlograms of Yt**



Similarly, the correlograms of Yt reflects that ACF exhibits dying out patterns of spikes and the PACFs contains only one significant spikes which replicates the nonstationarity outlines of the stochastic progression.

**Augmented Dicky-Fuller Tests (ADF) of the stationarity**

The stationarity of the Xt and Yt over periods in India can be tested with the help of ADF test. The relevant regression equations for ADF tests are

$$\Delta X_t = \alpha_1 + \beta_1 + \gamma_1 X_{t-1} + \delta_1 \sum_{i=1}^n \Delta X_{t-i} + \epsilon_{1t}$$

$$\Delta Y_t = \alpha_2 + \beta_2 + \gamma_2 Y_{t-1} + \delta_2 \sum_{i=1}^n \Delta Y_{t-i} + \epsilon_{2t}$$

Where the  $\epsilon_{1t}$  and  $\epsilon_{2t}$  are the white noise error terms and  $\Delta X_t = (X_t - X_{t-1})$  and  $\Delta Y_t = (Y_t - Y_{t-1})$

The optimum lag will be determined through Akaike Information Criterion. Again the estimated regression equation for the ADF tests involving differenced series for Xt and Yt are

$$\Delta^2 X_t = \alpha_3 + \gamma_3 X_{t-1} + \delta_3 \sum_{i=1}^n \Delta^2 X_{t-i} + \epsilon_{3t}$$

$$\Delta^2 Y_t = \alpha_4 + \gamma_4 Y_{t-1} + \delta_4 \sum_{i=1}^n \Delta^2 Y_{t-i} + \epsilon_{4t}$$

Where the  $\epsilon_{3t}$  and  $\epsilon_{4t}$  are the white noise error terms

**Results of the ADF Tests**

The results of the ADF tests for the presence of unit root test in the series concerned are being presented through the table 1

**Table 1**  
**ADF Unit Root Tests on X<sub>t</sub> and Y<sub>t</sub> in India**

Variable	Null Hypothesis	Lag length	ADF test statistics	Prob	Test critical values		
					1%	5%	10%
X <sub>t</sub>	X <sub>t</sub> has a unit root (intercept)	1	-0.377561	0.9034	-3.605593	-2.936942	-2.606857
Y <sub>t</sub>	y <sub>t</sub> has a unit root (intercept)	1	-0.916516	0.7727	-3.605593	-2.936942	-2.606857
ΔX <sub>t</sub>	ΔX <sub>t</sub> has a unit root (intercept)	0	-8.709518	0.00	-3.605593	-2.936942	-2.606857
ΔY <sub>t</sub>	ΔY <sub>t</sub> has a unit root (intercept)	0	-8.410770	0.00	-3.605593	-2.936942	-2.606857

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

The ADF test results shows that X<sub>t</sub> and Y<sub>t</sub> at levels are nonstationary since the null hypothesis of unit roots have been accepted at 1% levels of significance with intercept in maintained equations. But the 1<sup>st</sup> differencing leads to the ADF test results stationary since the null hypothesis of unit roots have been rejected at 1% levels of significance. Thus the X<sub>t</sub> and Y<sub>t</sub> attains stationarity at their 1st differencing and both are integrated of order 1 i.e. both series are I(1)

### Engle Granger Co-Integration Test

The Engle Granger Co-Integration test states that if two variables will be cointegrated when the linear combination of two nonstationary variables is stationary. In case of the Indian GDP and Plan expenditure, X<sub>t</sub> and Y<sub>t</sub> are found to be integrated of order two i.e. I(1). Now the linear combinations of these variables are

$$X_t = \alpha + \beta Y_t + U_t \quad (1)$$

$$\text{or } U_t = X_t - \beta Y_t - \alpha$$

$$\text{and } Y_t = \gamma + \delta X_t + V_t \quad (2)$$

$$\text{or } V_t = Y_t - \delta X_t - \gamma$$

Now if U<sub>t</sub> and V<sub>t</sub> are stationary i.e. I(0), then X<sub>t</sub> and Y<sub>t</sub> are cointegrated at level or CI (1,1). The Co-Integration of X<sub>t</sub> and Y<sub>t</sub> is examined through the estimating equation.

The regression equations are

$$X_t = .0035931 + .84679 Y_t$$

SE .0011642 .080498  
 t 3.0862\* 10.5194\*  
 P 0.00 0.000  
**SE = .0070391 R-Sq = .73450 R-Bar-Squared = .72786**  
**F = 110.6579; P = 0.000**  
**Durbin-Watson statistic = .98954**  
 The regression equation is  
 Again,  $Y_t = -.0017341 + .86739X_t$   
 SE .0012821 .082456  
 t -1.3526 10.5194  
 P 0.184 0.000  
**S = .0071242 R-Sq = .73450 R-Bar-Squared = .72786**  
**F = 110.6579; P = 0.000**  
**Durbin-Watson statistic = .98839**

Now the stationarity of the residuals  $U_t$  and  $V_t$  has been examined through ADF tests.

**Table: 2**  
**ADF Unit Root Tests on  $U_t$  and  $V_t$  in India**

Variable	Null Hypothesis	Lag length	ADF test statistics	Prob	Test critical values		
					1%	5%	10%
$U_t$	$U_t$ has a unit root (intercept)	2	-3.696832	0.0080	-3.610453	-2.938987	-2.607932
$V_t$	$V_t$ has a unit root (intercept)	2	-3.626525	0.0096	-3.610453	-2.938987	-2.607932

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

From the table 2 we have observed that the null hypothesis of unit root (with intercept in maintain equation) has been rejected at 1% level for both the equations. So the residuals  $U_t$  and  $V_t$  are stationry. Here  $X_t$  is CI(1, 1) cointegrated with  $Y_t$  and  $Y_t$  is CI(1, 1) cointegrated with  $X_t$ .

### Dynamic Relationship between GDP and Plan Expenditure in India

After examination of the Co-Integration analysis, we seek to estimate the VAR model to estimation in order to examine the cross equation shocks on the endogenous variables. The estimating VAR model of  $X_t$  and  $Y_t$  are considered as

$$X_t = \alpha_1 + \sum_{i=1}^k \beta_{1i} X_{t-1} + \sum_{i=1}^k \gamma_{1i} Y_{t-1} + U_{1t}$$

$$Y_t = \alpha_2 + \sum_{i=1}^k \beta_{2i} Y_{t-1} + \sum_{i=1}^k \gamma_{2i} X_{t-1} + U_{2t}$$

For determination of the optimum lag length we followed the VAR lag order selection criteria.

**Table 3**  
**VAR Lag Order Selection Criteria**  
**Endogenous variables: Xt Yt**  
**Exogenous variables: C**

Lag	LogL	LR	FPE	AIC	SC	HQ
0	258.9262	NA	9.04e-09	-12.84631	-12.76187	-12.81578
1	313.0387	100.1081*	7.38e-10	-15.35193	-15.09860*	-15.26034*
2	318.0606	8.788406	7.03e-10*	-15.40303*	-14.98081	-15.25037

\* indicates lag order selected by the criterion

LR: sequential modified LR test statistic (each test at 5% level); FPE: Final prediction error; AIC: Akaike information criterion; SC: Schwarz information criterion; HQ: Hannan-Quinn information criterion

This table shows that the lags of order one is sufficient, which conforms by the LR, Scand HQ criterion but AIC and FPE indicates two lags of order. Hence, it is possible to observe the VAR model with the lags interval .1: 2.

**Estimation and Results of VAR model**

The results of the estimation of the VAR model are being presented through the tables

**Table: 4**  
**Result of the VAR Estimation**

Dependent Variable	Regressor	Coefficient	Standard Error	T-Ratio
Xt	c	-0.000175	(0.00092	0.19050
	Xt(-1)	<b>.30594</b>	<b>.15583</b>	<b>1.9633*</b>
	Xt(-2)	.19361	.13117	1.4760
	Yt(-1)	.19348	.13331	1.4514
	Yt(-2)	<b>.30580</b>	<b>.15474</b>	<b>1.9762*</b>
	$R^2 = .89992$ ; Adjusted $R^2 = .89158$ ; F-statistics= 107.8997*; DW = 2.6082			
	c	-0.000379	0.00113	-0.33620

<b>Y<sub>t</sub></b>	<b>Y<sub>t</sub>(-1)</b>	<b>0.67802</b>	<b>.16414</b>	<b>4.1307*</b>
	Y <sub>t</sub> (-2)	.34483	.19052	1.8099
	X <sub>t</sub> (-1)	-.036109	.19187	-1.8820
	X <sub>t</sub> (-2)	-.070984	.16151	-0.43951
	<b>R<sup>2</sup> = .85379 ; Adjusted R<sup>2</sup> = .84161; F-statistics = 70.0740* ; DW = 1.9956</b>			

From the *table:4* with X<sub>t</sub> as dependent variable  $\beta_{11}$  and  $\rho_{12}$  are significant at 1% level and greater than zero. Here  $\beta_{11} > 0$  indicates that GDP is positively related to the one period lagged value of the GDP and  $\rho_{12} > 0$  indicates that two periods lagged plan expenditure also affect the current GDP even in the presence of the lagged GDP in the vector of repressors. It implies the possibility that Plan Expenditure Granger caused GDP in India. The elasticity coefficient  $\rho_{12} = 0.306$  implying that the GDP rose by only 31% of a rise in Plan Expenditure in the previous two lagged periods. The VAR Granger Causality/Block Exogeneity Wald Tests also satisfied the significance of Plan Expenditure Granger caused GDP in India.

Similarly with Y<sub>t</sub> dependent variable  $\beta_{21}$  are significant and  $\sum_{i=1}^2 \beta_{2i} < 1$ ,  $\sum_{i=1}^2 \gamma_{2i} < 1$ , so the lagged structure are consistent and the significant F- statistics indicates that the estimated equation is a good fit free from autocorrelation. However, the GDP Granger has not caused plan expenditure (rejected by Granger Causality/Block Exogeneity Wald Tests) but one period lagged GDP helps to increase in the current period GDP.

### Stability of VAR Model

The condition of the stability of the VAR model is evaluated by examining the characteristics roots of the following model:

$$A(L) X_t = \alpha_1 + \sum_{i=1}^2 \gamma_{1i} Y_{t-i} + u_{1t}$$

$$B(L) Y_t = \alpha_2 + \sum_{i=1}^2 \gamma_{2i} X_{t-i} + u_{2t}$$

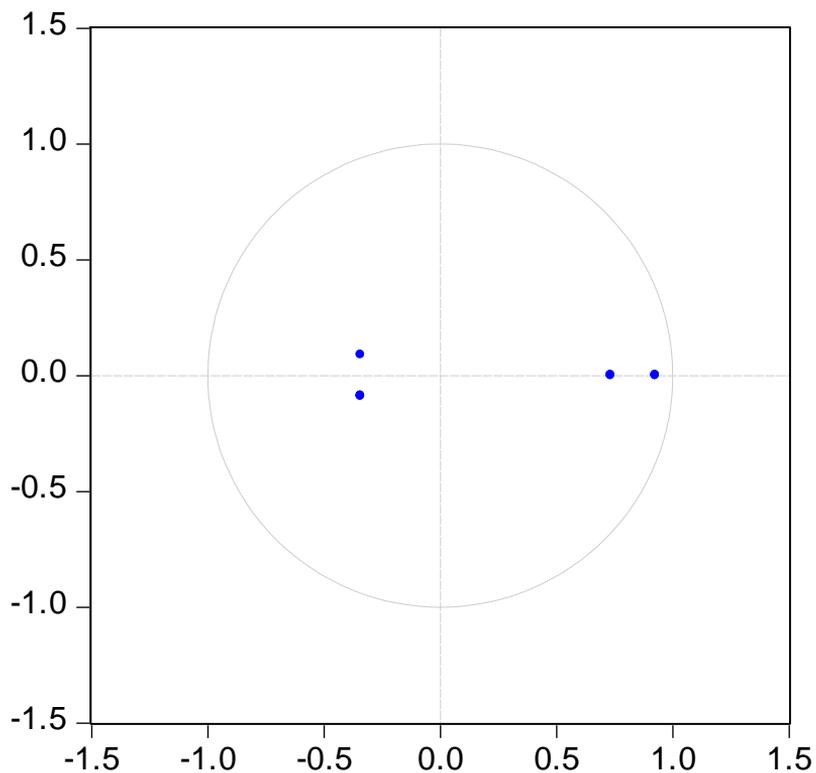
**Table: 5**  
**VAR stability condition**  
**Endogenous variables: X Y; Exogenous variables: C**  
**Lag specification: 1 2**

Root	Modulus
0.925509	0.925509
0.735286	0.735286
-0.341119 - 0.088108i	0.352314
-0.341119 + 0.088108i	0.352314

\* No root lies outside the unit circle.

\* VAR satisfies the stability condition.

**Figure:4**  
**Inverse Roots of AR Characteristic Polynomial**



The absolute value of the roots is less than unity and of which two positive roots are significantly different from zero. On the other hand the no roots lie out circle which testify the stability of the VAR system (Figure:)

Thus from the whole stochastic analysis of the Plan Expenditure and GDP of India analysis reflects that Plan Expenditure Granger caused GDP in India and a rise in plan expenditure will cause a rise in GDP of India. So there is considerable contribution of planning expenditure on GDP right from 1950 to 2010 in India. On the other hand one period lagged GDP helps to GDP of India sustains itself and reduces the pressure of planning commission. So there is a considerable effect of Plan expenditure on the GDP of India but in reverse GDP rise further reduce the Plan expenditure in India.

### **India Planning and Transformation**

While India adopted planning under a strong interventionist circumstances its approach to planning differed in several crucial respects from that of the socialist economies. In India, the means of production have been and continue to be privately owned and regardless of the significant expansion of the public sector, the private sector owns more than half of the resources stockpile and accounts for nearly three-fourths of the annual output. Planning in India has brought about major structural shatters which are viewed as a way of avoiding the unnecessary rigours of an industrial and equally India's development prospects were rated rattier high, domestically as well as internationally (Rao. 2006. P. 452). However, in the nineties with the collapse of USSR and many of the East European socialist economies, the centralized planning as a tool of economic development has come under severe attack. There is a move towards decentralized and indicative planning world over. The spectacular development experience of the East Asian economies also point to the strong role of indirect state intervention through manipulating market mechanism in the development process. The role of planning is as a result, undergoing changes where the private sector is being encouraged much more to achieve the socially desirable outcome. The approached paper of the 11<sup>th</sup> five year plan also recognised the relative roles of the planning commission in private economy and stated that economic policy is moving in a direction that involves an erosion of the role of the state in the development process. However the objective of accelerating growth cannot be achieved without expanded role for the state in some areas. In fact the role of the government needs to be restructured to reduce direct intervention in, and commitments of scarce public resources to, areas where the private sector operating under competitive markets can deliver.

### **Budgeting for Planning**

Generally the Govt has to incur certain portion of funds every year of funds for fulfilling planning which is different in year wise phasing. However, the resources generally fall much short in India of what would be indispensable to accomplish the plan targets. The situation is such in certain areas that there is no certain plan model to estimate the expenses such as defence budget. Now India's defence expenditure is

2.5% of its GDP. Sometimes it also happens that some certain sudden external shocks arise which replicate the budget expenditure. For example, during 1960s Indian planning suffered two major shocks caused by exogenous factors in the 1960s. The first came in the shape of the war with China in 1962 and the second in the form of successive harvest failures in 1965 and 1967. The first shock caused a sharp increase in India's defence outlays and a severe curtailment in public investment of the government. That would call for planning in terms of building up capability to meet threat perceptions or force planning which are critical for making any meaningful estimates for defence needs (Larson and Kristin 2001. P.23):. If the amount available falls short of the estimated requirements, the planning commission should overcome this by mobilising more resources through raising revenue or cutting expenditure. So in such circumstances planning is not directive rather a force one.

**Table: 6**  
**Central Government: Revenue, Expenditure and Fiscal Deficit**  
**(% of GDP at current market prices)**

Expenditure Heads	Total Revenues	Tax Revenues	Non-tax Revenues	Recovery of Loans	PSU Disinvestment	Total Expenditure	Interest	Defence	Subsidies	Plan Expenditure	Other Expenditure	Fiscal Deficit
1990-91	10.67	7.56	2.11	1.00	0.00	18.52	3.80	2.71	2.12	4.99	4.90	7.85
1991-92	11.50	7.67	2.44	0.92	0.47	17.06	4.10	2.71	1.88	4.74	3.90	5.56
1992-93	11.02	7.22	2.68	0.85	0.47	16.38	4.20	2.35	1.45	4.90	3.50	5.37
1993-94	9.50	7.22	2.56	0.72	-0.01	16.51	4.30	2.54	1.35	5.08	3.30	7.01
1994-1995	10.12	6.66	2.33	0.63	0.50	15.87	4.40	2.30	1.17	4.68	3.30	5.75
1995-96	9.85	6.90	2.37	0.55	0.03	15.01	4.20	2.26	1.07	3.90	3.60	5.16
1996-1997	9.81	6.85	2.38	0.55	0.03	14.69	4.30	2.16	1.13	3.91	3.10	4.88
1997-1998	9.81	6.28	2.51	0.55	0.06	15.24	4.30	2.32	1.22	3.88	3.50	5.84
1998-1999	9.53	6.01	2.58	0.61	0.34	16.04	4.50	2.32	1.36	3.84	4.10	6.51
1999-2000	9.90	6.60	2.70	0.50	0.10	15.30	4.60	2.40	1.30	3.90	3.10	5.40
2000-01	9.90	6.50	2.70	0.60	0.10	15.50	4.70	2.40	1.30	3.90	3.20	5.70
2001-02	9.70	5.90	3.00	0.70	0.20	15.90	4.70	2.40	1.40	4.40	3.00	6.20
2002-03	10.90	6.50	2.90	1.40	0.10	16.80	4.80	2.30	1.80	4.50	3.50	5.90
2003-04	12.60	6.80	2.80	1.40	0.60	17.10	4.50	2.20	1.60	4.40	4.40	4.50
2004-05	11.80	7.10	2.60	2.00	0.10	15.80	4.00	2.40	1.50	4.20	3.70	4.00
2005-06	9.66	7.55	2.15	0.30	0.04	14.13	3.70	2.25	1.33	3.93	2.92	4.09
2006-07	9.66	8.20	1.94	0.14	0.01	13.62	3.51	2.00	1.33	3.97	2.82	3.33
2007-08	10.95	8.88	2.07	0.10	0.78	14.40	3.46	1.85	1.43	4.14	3.52	2.56
2008-09	9.69	7.9	1.74	0.11	0.01	15.86	3.45	2.05	2.33	4.94	3.10	6.05
2009-10	9.37	7.55	1.82	0.11	0.42	15.99	3.56	2.21	2.13	4.94	3.10	6.05
2010-11	9.84	7.70	2.14	0.07	0.58	15.99	3.56	2.12	1.68	5.38	3.22	5.50

Source: Planning Commission

In the table, the plan expenditure shows a steady relationship with the revenue over the years in India. The revenue, expenditure and fiscal deficit are remaining the same with respect to GDP showing a little tendency of decline. So planning process

needs incorporate these deficits to have continuous expansion of the economy.

### **Long term Perspective in Planning and Budgeting**

Instead of focusing only on the upcoming year the budget should have a longer term outlook and dedication broadening beyond one year. Since five years may be too long and the budget should be set in a more time frame, so many countries in the world now regularly prepare their investment plan as an integral part of their annual budget making. In a multi-year budgeting framework these plans should also reveal the private investment patterns relative to what was assumed in the original five year plans (Parikh. 1993 P. 656). Along with multi-year budgeting reform is needed also in the system of expenditure classification in the government budgets. In case of Malaysia, the national planning mechanism comprising long-term perspective planning (10-20 years), medium term (5 years) and short term (annual) ensures that the country meets the overriding development goal of national unity. The long-term perspective planning includes the First Outline Perspective Plan that contained the New Economic Policy (1971–1990), the Second Outline Perspective Plan (OPP2) containing the National Development Policy (1991–2000) and the Third Outline Perspective Plan, which accommodates the National Vision Policy (2001 – 2010). Thus in India, although there is no apparent link between the annual budgets and the five year plans, expenditures set out in the budget are required to be classified in a manner that carries a positive impact to the contrary. In the absence of any link between the budgets and the five year plan, the rationale of development is not served.

### **Crises of Confidence**

The frequency of crises in recent years has drawn attention to the weaknesses in the international financial system. Each of the major crises in the 1990s - Mexico in 1994, East Asia in 1997, Russia in 1998 and Brazil in 1999 and global financial crisis of 2007-2008 had features peculiar to itself but they all shared an important common characteristic. They were crises of confidence originating in the capital account and therefore very different from earlier episodes of payments problems in developing countries which typically arose in the current account. The vulnerability of Indian economy to such crises has increased from the 1990s as it had liberalized restrictions on capital movements in order to integrate more fully into global financial markets and improve their access to international capital flows. Any financial crisis may form an economic disaster the ultimate effect will be on both budgeting and planning models. So Planning process of India urgently needs to comply with the market directives while forming and implementing the plan model. The reforms currently underway in the banking sector and in the capital market, combined with the agenda for reform identified for the insurance sector, represent a major structural overhaul of the financial system. It will certainly bring India's

financial system much closer to what is expected of developing countries as they integrate with the world economy (Premchand, 2001. P. 43). It is essential to continue these reforms along the directions already indicated and to accelerate the pace of change as much as possible. It is also important to recognize that financial sector reforms by themselves cannot guarantee good economic performance. That depends upon a number of other factors, including especially the maintenance of a favorable macroeconomic environment and the pursuit of much needed economic reforms in other parts of the real economy.

### **Fiscal Autonomy of the States and Transfer System**

A major factor that has impeded the realisation of the goals of planning has been the tendency on the part of the centre to manage state events from central level. Soon after planning was launched, powers of controlling manufacturing investment in the private sector were occupied by the centre complemented by the control over financial institutions. Even though some liability for delivering public services was dispersed to the states by the constitution, the states were supposed to follow the dictates of the centrally designed plan. However things seemed to change with liberalisation. Demanding cooperative federalism, the states seemed to be regaining their autonomy in economic policymaking. It was expected that the twin imbalances that marked the federal fiscal system would be taken care of through transfers mediated by the finance commission. The results achieved have however fallen short of expectations in important respects. So in implementing economic reforms needed to push the economy forward there is no alternative but to reform the fiscal institutions of the federal system. In the path of this transition from plan to market economy, it is needed to reforms Indian fiscal policies and institutions.

### **Conclusion**

It is widely recognized that India's planning process has been one of the most consistent among such efforts undertaken in the Third World. The Plan efforts have contributed significantly in many fields, most notably in the increase in food production. However, a number of problems still remain. The desire for planning at multiple levels remains largely unrealized despite the commitment made by successive governments. This contradiction has seriously undermined the concept of making planning more democratic and responsive to people's aspirations. Further, regional inequalities and income inequalities persist in India despite planned economic development. This is a serious problem, which if uncorrected, can lead to more strain on the political fabric of the Indian state. Centre state relations, particularly in regard to planning functions and powers to mobilize financial resources, have been under stress. At the same time public resources are needed to be used optimally and thus planning is needed even in a market economy. However, the function of planning in a predominantly market-driven economy has to be

symptomatic, co-coordinative and authoritarian. That provides the good reason for India's Planning Commission to engage in preparing development plans for the economy periodically even after liberalisation. The Co-Integration analysis of plan expenditure of India and GDP also indicates that there is a close relationship in between them and Plan expenditure leads to expansion of GDP in pre-liberalization periods. However, as it can't control investment in the private sector so such planning can at best be at least indicative. So the hypothesis that there is no interrelation in between the plan contribution and national income expansion from the time period of initiation of planning process in India is rejected as directed by the VAR model. But the five year plans are now seek to provide an indicative path of development by setting out the imperatives for alternative growth scenarios in terms of macro-variables. It is still be necessary for planning commission to integrate and coordinate the plans of different ministries and undertakings of the central government, and bring them in line with the medium and long-term goals while keeping within the budget constraint. At the same time, the system of transfers from the centre needs to be reformed. There should be some rethinking on the relative roles of the planning commission and the finance commission.

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## THE REGIONAL DISPARITIES OF THE FDI IN ROMANIA

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### Abstract

*Following the collapse of communism, the countries of Central and Eastern Europe, have been forging strategies to attract foreign capital as a way of achieving sustained economic growth (Martin and Velázquez, 2000). Foreign direct investment by multinational corporations plays an important role in the transformation of former centrally planned economies into vibrant market systems, since it provides an inflow of capital, management skills, and jobs, alongside increasing exports and transfer of technology. It is also perceived as one of the conditions paving the way for improving the competitiveness of the economy and enhancing the provision of goods and services for the domestic market.*

*With the implementation of global and regional strategies by multinational corporations, the choice of location is becoming increasingly important, hence requiring a better understanding of the internationalization process and of the factors influencing the spatial distribution of FDI. There are substantial differences in economic performance across regions in virtually every nation. This suggests that many of the essential determinants of economic performance are to be found at the regional level (Porter, 2003, p.550).*

*In this paper we shall make an analysis of regional disparities of the FDI in Romania using the data provided by the National Trade Register Office of Romania for the period 1991-2008 and National Institute of Statistics.*

**Keywords:** foreign direct investments, regional disparities, multinational corporation, economic development

**JEL Classification:** O11, R12.

### 1. Administrative Divisions in Romania

After 1990, Romania shifted its spatial policy from a central-based policy to a regional-based policy, in compliance with EU-standards. According to four criteria

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(number of inhabitants, surface, cultural identity and functional-spatial relations); Romania was divided 1998 into eight Development Regions. The eight regions serve as NUTS-II units and as a framework for development policies while the counties serve as NUTS-III units. The NUTS-II units are: **North-East development region** (Bacau County, Botosani County, Iasi County, Neamt County, Suceava County, Vaslui County), **South-East development region** (Braila County, Buzau County, Constanta County, Galati County, Tulcea County, Vrancea County), **South development region** (Arges County, Calarasi County, Dambovita County, Giurgiu County, Ialomita County, Prahova County, Teleorman County), **South-West development region** (Dolj County, Gorj County, Mehedinti County, Olt County, Valcea County), **West development region** (Arad County, Caras Severin County, Hunedoara County, Timis County), **North-West development region** (Bihor County, Bistrita County, Cluj County, Maramures County, Satu Mare County, Salaj County), **Center development region** (Alba County, Brasov County, Covasna County, Harghita County, Mures County, Sibiu County), **Bucharest-Ilfov development region** (Ilfov County, Bucharest).

## **2. The analyze of the distribution of foreign capital investment on economic development regions**

The Bucharest-Ilfov region keeps its primacy in receiving foreign investments, accounting for 57.1% of them and an amount of 15185575.5 thousands USD and a number of 74788 foreign companies in 2008. This situation is motivated by the still precarious transport infrastructure connecting the rest of the country with Europe and the whole world, by the qualified and very skill workforce residing in Bucharest – the capital city is the most important academic center in Romania and the most of the students start working while still studying and thus being motivated to keep working and living in Bucharest after finishing their studies. Another favorable point for the skilled and very well prepared workforce in Bucharest is represented by the professors activating within the universities from Bucharest as well as the very well trained personnel working in all the other companies from the region.

The second most important region for the foreign direct investments flow is the South East region that benefits from transport facilities offered by the Black Sea and the Danube. The most important center in this region are Galati (the city of the steel producer Ispat SIDEX owned by the LMN Holding and of the ship constructor company “Santierul Naval Galati”, the second ship producer in Romania) and Constanta (the second town of the country in terms of population, the most important port in Romania and the fourth European port).

The foreign investors’ interest in the Western regions can be noticed, fact can be explained by the greater stability of the foreign capital invested of the Western region compared to the other regions of the country, the lower salaries and leaving standards compare with Bucharest, by the transport infrastructure that has improve lately for this region, the airports in the most important cities in the region being

modernized and connected with the most important cities in the Western Europe, but also by the more Western – like life style and mentality from this region. The most important economic centers in this region are Timisoara (the second developed city of Romania after Bucharest) and Arad.

The other development regions don't have noticeable performances in terms of attracting of foreign direct investments. The main factors can contribute to the raise of FDI flows in these regions are the capital stability and a proper infrastructure.

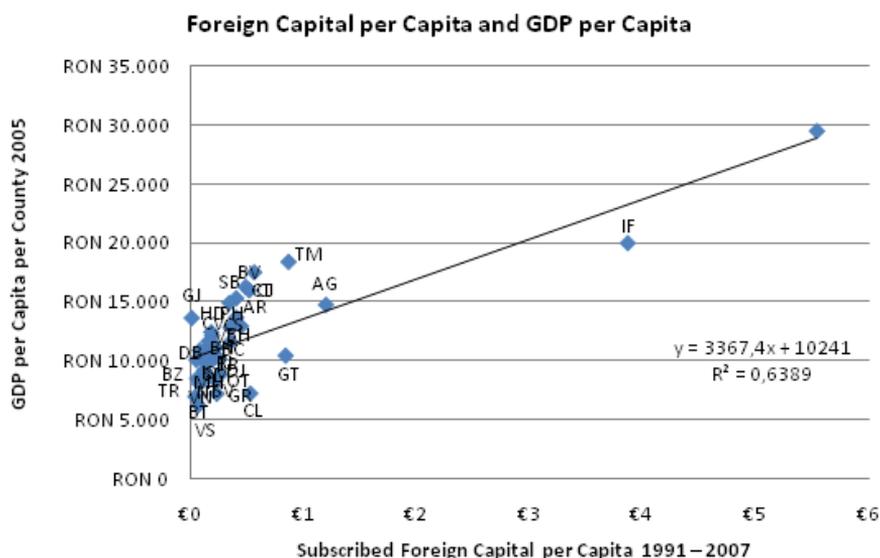
*Table 1:*

**The distribution of the foreign capital investment on economic development regions – 2008**

Country	Number of companies		Amount of subscribed capital	
	Number	%	Thousands USD	%
Country	153118	100	26557877.1	100
North East	6647	4.3	1585436.4	5.9
South East	8843	4.8	1719831.1	6.4
South - Muntenia	7206	4.7	2318962.7	8.7
South West - Oltenia	4062	2.7	608659.3	2.2
West	18038	11.8	1631974.9	6.1
North West	17396	11.4	1455436.4	5.4
Center	16138	10.5	2052000.8	7.7
Bucharest-Ilfov	74788	48.8	15185575.5	57.1

Source: [http://www.onrc.ro/statistici/is\\_december\\_2009.pdf](http://www.onrc.ro/statistici/is_december_2009.pdf)

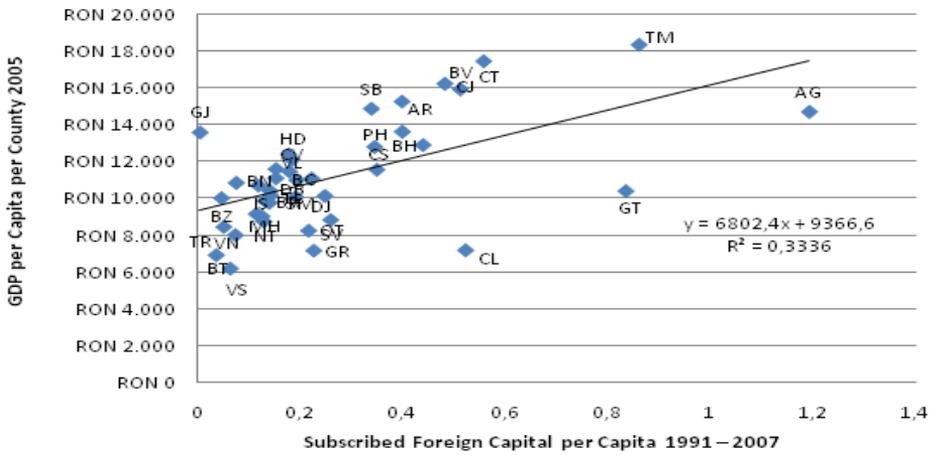
**Graph 1: Location Decisions for Foreign Direct Investments in Romania**



Source: <http://www.onrc.ro/>

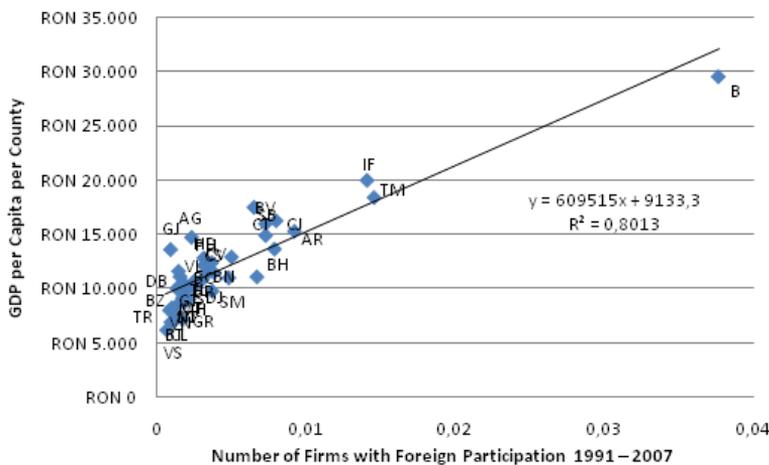
A comparison with former reports suggests that it were continuously the same counties which attracted the lion's share of foreign participation firms. There is – of course – a strong relationship between **FDI** in monetary terms and economic performance (GDP per capita) in Romania but it diminishes once the driving forces Bucharest and Ilfov are removed (cf. Graph 1 and Graph 2). The main outliers are the three counties Călărași, Argeș and Galați. Argeș e.g. is dominated by Automobile Dacia SA, Renault and some other suppliers of the automobile industry such as Draxlmaier or Galați by a huge steel combination and power central.

**Graph 2: Location Decisions for Foreign Direct Investments in Romania**  
**Foreign Capital per Capita and GDP per Capita minus B and IF**



Source: <http://www.onrc.ro/>

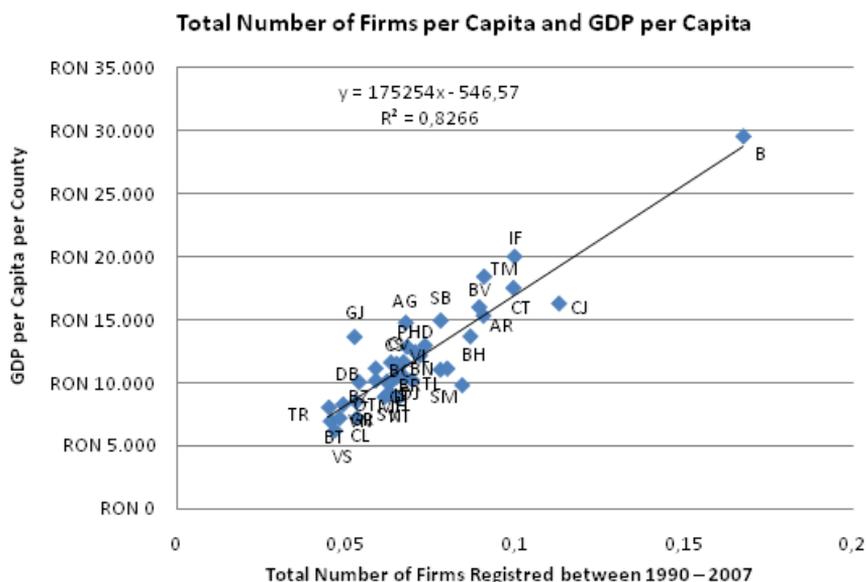
**Graph 3: Business in Romania – Location and Investment Decision**  
**Foreign Firms per Capita and GDP per Capita**



Source: <http://www.onrc.ro/>

On the contrary, the number of firms with foreign participation per capita in Romania is very unevenly distributed among the counties and a much better predictor for economic well being and attractiveness. Additionally, it provides a relation which remains perfectly stable after the extreme cases like Bucharest and Ilfov are removed ( $R^2 = 0.64$ ), thus the data fit remains even better as of the monetary indicator including Bucharest and Ilfov.

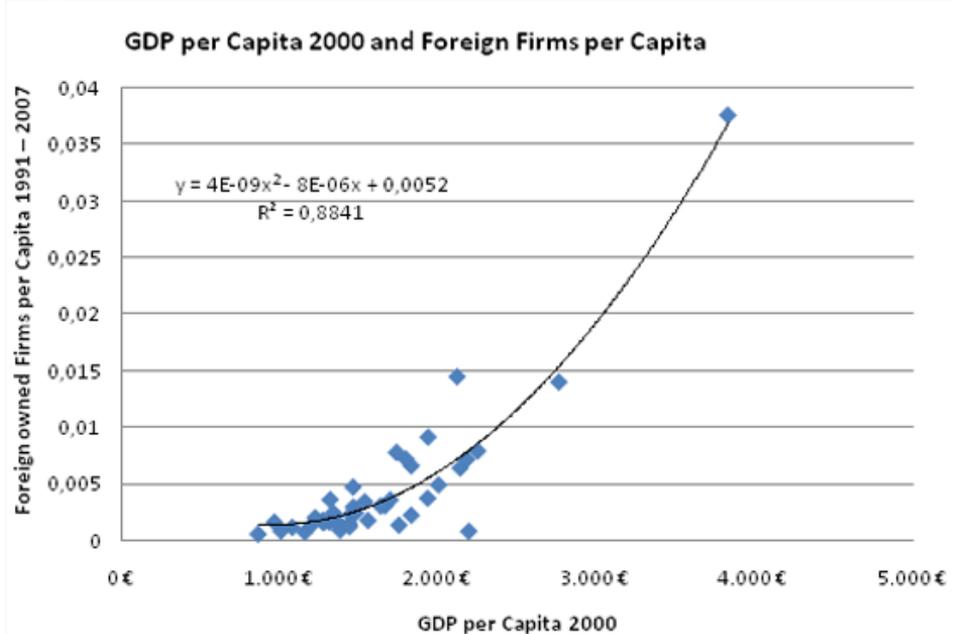
**Graph 4: Doing Business in Romania: Drivers of Investment and Location Decisions**



Thus, local economic performance and attractiveness to FDI in Romania are better expressed by the number of firms with foreign capital on the local level (NUTS-III), not by the money included. This is quite reasonable as some lagging counties attracted large amounts of foreign capital due to the privatization of the heavy industry (such as the steel and energy sector or the automotive industry). Then again, these activities do not guarantee prosperity for the county as a whole nor seem these counties to be too attractive for other kinds of investors, yet. The pattern persists and even stabilizes with regard to linearity if the total number of firms, both entirely domestic and with foreign participation is taken into account. The total number of firms is captured here again with data from ONRC as registered companies between 1990 and 2008 and adjusted for county population size. A closer look on the counties Călărași, Argeș and Galați reveals now that economic activity is rather low and clearly below the mean what is also reflected in lower per capita GDP. Hence, the monetary large-scale investments there seem to be quite isolated.

Accordingly, regional disparities in terms of attractiveness to **FDI in Romania** on the local level will be measured henceforth as the number of firms with foreign participation (per capita), not in monetary terms. Likewise, overall attractiveness to economic activity in general will be measured as from now on as the total number of firms registered per capita (cf. Graph 4). This is justified as the number of firms seems to be a better indicator for attractiveness and economic performance in Romania than monetary flows, because the latter are distorted by isolated large-scale investments in heavy industries and energy sectors. This is also in line with findings from Kaminski & Ng (2004) and World Bank (2004) which underpinned the importance of SMEs for the Romanian economy and export performance.

**Graph 5: Business Activities in Romania – Location Decision Patterns**

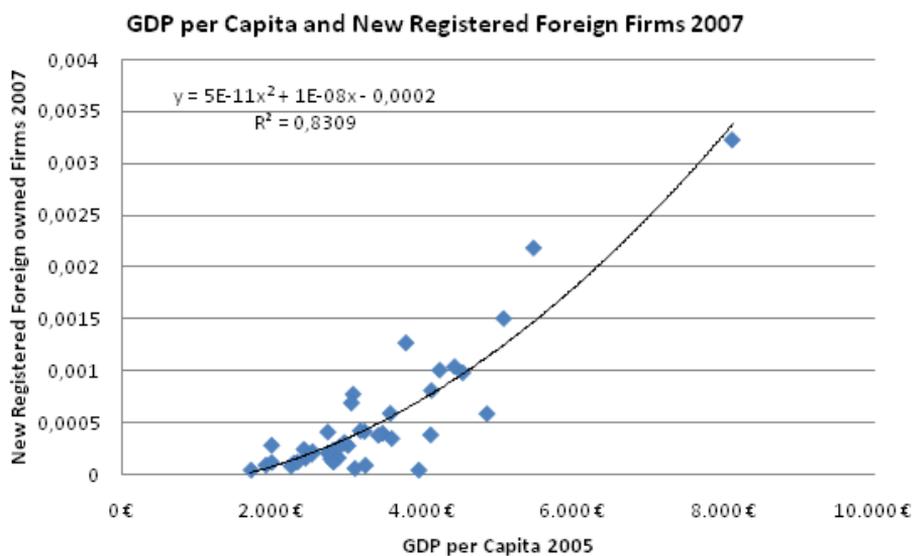


Source: <http://www.onrc.ro/>

An interesting observation to be made in this regard is the confirmation of several business articles which describe foreign economic activity as concentrated in few economic centers, despite labor markets being swept clean and significantly higher salaries for qualified labor and sometimes even for unqualified labor.

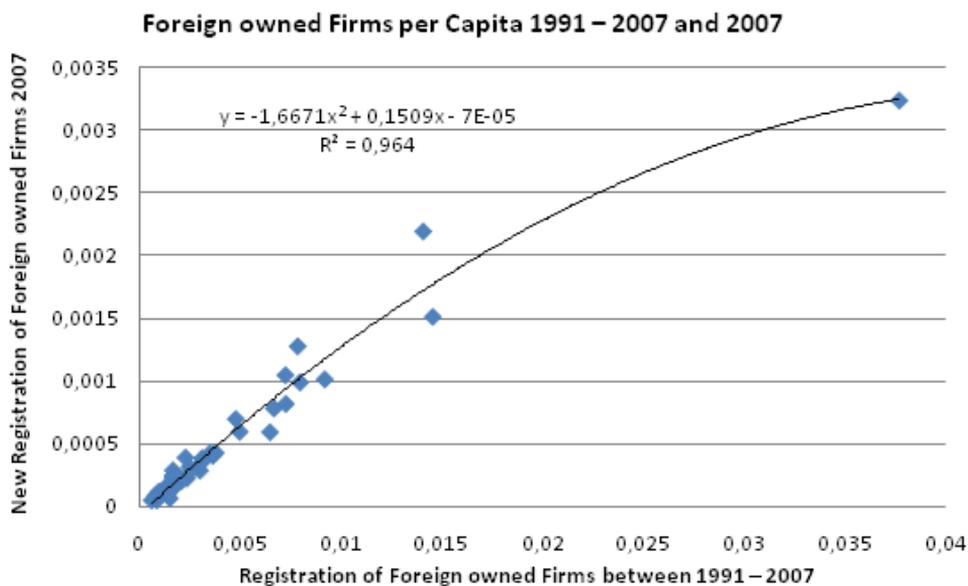
One could of course argue that this relationship actually works the other way round. That is to say that per capita GDP is higher because of the higher (foreign) economic activity. But first, this notion would not explain why the respective counties were initially chosen (or avoided) by foreign investors as they were, second, already better developed before and third, the trend still persists as Graph 6 indicates. The registration pattern from 1991 to 2008 correlates almost perfectly with the new registration during 2008 (cf. Graph 7).

**Graph 6: Business Activity in Romania – Location Decisions**



Source: <http://www.onrc.ro/>

**Graph 7: Foreign Companies and Investments in Romania – Location Decisions**

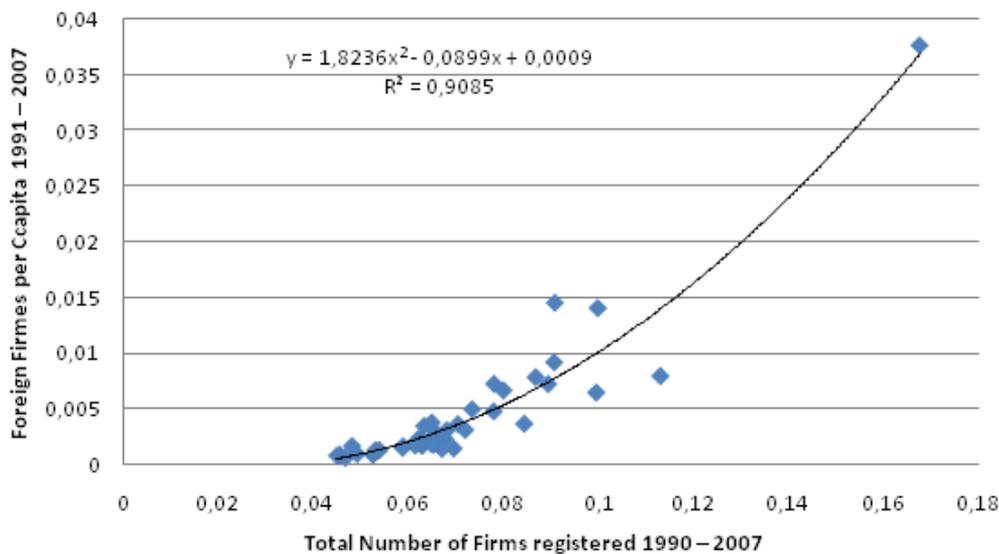


Source: Commission Services (Ameco)

The result of this concentration of economic activity is not only higher GDP per capita for the lucky counties but often also full employment and a sharp concurrence on labor resources. At the same time other counties still feature excess labor force and ought to have a higher MPK judged over their lower GDP per capita

levels. Total economic activity and foreign economic activity are highly but not perfectly correlated. In particular, the relation does not seem to be a strict linear one (cf. Graph 8) even though also a linear model fits well ( $R^2 = 0.826$ ).

**Graph 8: Economic Activity in Romania – Location and Investment Decision Patterns**  
**Total Economic Activity and FDI-Activities 1991 – 2007**



Source: <http://www.onrc.ro/>

### Conclusion

The analysis of the investment's location within Romania shows a very disparate distribution of FDI in the eight development regions. It is mainly due to the very heterogeneous development areas with big cities not so economically diversified, with mono-industrial, small towns, strongly affected by privatization and the restructuring process and with some urban centers that proved their incapacity of becoming development vectors for the area around them. The under developed regions are those where agriculture is predominant, having a great rural population and where transport and the means of communications are very little developed.

The main determinants of the FDI localization at the regional level are the following: the privatization process, the economic development, the low-cost workforce and qualified workforce and the quality of the infrastructure.

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## IMPROVEMENT OF FINANCIAL TREASURY SYSTEMS EFFICIENCIES' THROUGH INFORMATION TECHNOLOGY

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### Abstract

*This article explores the significance and contribution of Information Technology (IT) in improving the efficiencies of financial systems, especially treasury systems, related to ministry of Finance in Albania as a case study. All this process, further, will have direct impact in macro level, especially referring creating and improving a knowledge based economy, through specifically, contributing in finance and government. This new technological development in the financial industry is known as "e-finance" in the literature. Following the development of the Internet and IT and their continuously growing implementation in all fields of the contemporary society, the economic entities are provided with unlimited opportunities for improving their effectiveness and efficiency, as well as for achieving higher competitiveness on the global market. As moving from an industrial to information society will bring us soon in the path of knowledge based economy.*

*Should Albania be the proper case of following the model that it's based on it? Are we ready to follow up on this way? How much effective we can be? What are the Albanian experiences on this model? What we propose? These, are some of the main questions that the authors intend to gives answer. This paper is based in a detailed treatment of theory and comparing the results and discussion with Albanian case, but not only. There are treat also some other cases.*

*This article conclude that the use of IT has fundamentally improved the efficiency and the quality of government services and financial institutions.*

**Keywords:** financial systems, Treasury System IT, e-Finance, Albania Ministry of Finance.

**JEL Classification:** G0, M15, O32.

### 1. Introduction

The world has already been moved from the industrial economy to the networked and digital economy. In this new informational era, characterized by the fast growth and development of IT (Information Technologies), a further and faster expansion of internationalization and globalization processes can be witnessed. The economic world has moved from cluster of national economies to a global, wide,

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international marketplace. Though, the emergence of global business models based on digital technologies and Internet has become an imperative for companies of all size.

“Information and Communications Technology” refers to all technologies and services that enable information to be accessed, stored, processed, transformed, and disseminated, including the transmission or communication of voice, image, and/or data over a variety of transmission media and exchange of information and communication services. Information system are usually applied in the newly developed industries. Moreover, the use of IT may spur the further integration of the financial institutional markets across nations. During the last decade, information technology has profoundly changed the landscape of financial markets and even the governments, becoming and transforming in this way many economies in different countries. The use of IT has fundamentally improved the quality of government services and financial institutions. This dramatic development, known as e-finance and e-government, has become a focal point of practice in many countries with aim of developing a economy based on

## 2. Literature review

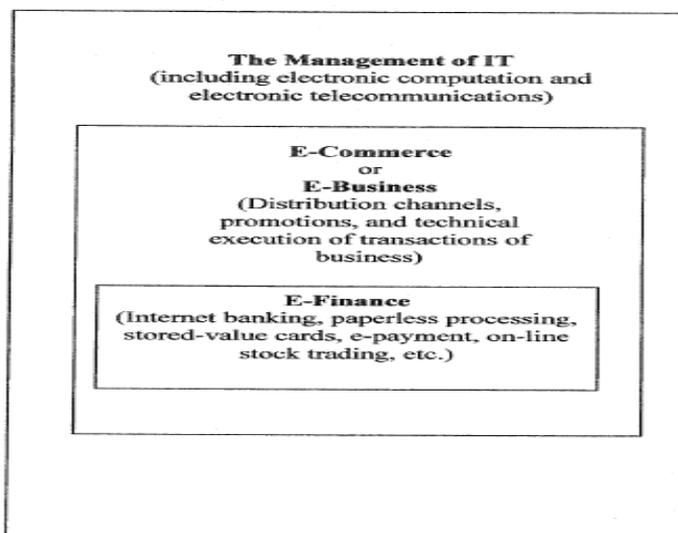
During the last decade, IT has profoundly changed the landscape of international financial markets. Some european develepd countries are changed due to this new trend, some other as emerging markets have become considering the largest customer in the IT in the economy (Frei, et al., 2008). The use of IT hav overwhelmingly and fundamentally improved the quality of financial services and operation of government finance (ministries or finance agencies).

What is e-finance? Hartmann (2002) defines e-finace as “Transaction in which funding for an economic activity is provided thourugh an electronic communication medium”. By definition, e-finance is a branch of e-commerce and e-government os therefore an application of e-finance (Allen et al., 2002)

Internationalization of financial institutions and governments is support by IT as a path through the e-based services. Many countries have joined the European Economic Union and the World Trade Organizations. Also, services, goods are allowed to move easily across the national boundaries, meaning that international harmonization of regulation in financial markets is expected (White, 2000). The diffusion of e-finance technology across nations further speeds up to the transmission of information in different countries. This means that, the global financial markets could become more unified than before due to the progress of e-finance (Claessesn, 2004). What result for the literature is that *financial institutions are the major customer of IT*, justifying substantial IT investment has become necessary and important (Allen et al., 2004). There are some advantages from the presence of IT in financial markets. Therefore, an investigation of the international market’s integration of financial intermediaries along with the development of Information Technology is important. Also, IT has brought the “*technological change*” among the

financial institutions. This concept is too broad to capture the contribution of IT. Therefore, it is critical to evaluate the impact of IT on the financial industry. We should say that it is important to investigate and evaluate the impact of IT on financial markets, institutions, government and services *across different nations*, given that the world economy is increasingly globalizing.

Figure 1: Relationships among IT, E-Commerce, and E-Finance



*This figure shows the theoretical relation between information technology, e-commerce and e-finance. This figure anticipates the treated case.*

### **How much IT has impact on knowledge?**

The use of information technologies (IT) is an essential component of modern day societies and economies. IT is required for modern businesses and governments to operate efficiently and enhance service delivery to the public and to the private sector among others. People also require IT so that they can take advantage of these efficiencies and services in order to improve their quality of life and become more self-sufficient.

Economies are increasingly based on knowledge input, which has always been the main source of long term growth. More significantly, the endogenous growth approach since the late 1980s is based on the creation of knowledge in human beings, so called "human capital". It is difficult to measure this innovative input output for modeling a knowledge based economy. What literature reflects is regard to the fact that the technological innovation is driving the globalization process and involves the increasing integration of national economic systems, which are necessary and reasonable world market oriented. What follows from the literature review concern that *computer using, or computer dependent industries as finance, insurance and*

*real estate and other services have continued to lag in productivity growth.*

Oliner and Sichel (1994) examined how much computing equipment have contributed to economic growth since 1970 and has arrived at three main results:

1. Under the assumption used for the baseline growth accounting, the contribution of computer hardware in gross output was low between 1970 and 1992.

2. Their estimate of adding software and computer services labor approximately doubles the contribution of hardware.

3. Continued rapid growth in the stock of computer hardware and software probably will not generate a substantial upturn in computing services' contribution to output growth, unless there is a dramatic surge in the rate of return earned by computers.

There are two important factors as the sources of the increased knowledge:

1. First, it is population growth. The other is that the rising real per capita income has made it possible specialized in the production of knowledge. A larger population leads to greater creation of knowledge. First, the larger the population is, the greater the benefit in productivity results from new knowledge.

2. Second, with a larger population, there are more individuals capable of making a significant discovery in knowledge.

Lastly, the new economy is also a knowledge economy based on the application of human know how to all output that is produced. In the new model economy, more and more of the economy's added value will be created by brain power rather than brawn, and creating new products and adapting existing products will form the future. With knowledge becoming the key source, there is only a world economy, even though the individual organization can operate in a national, regional, or local setting.

### **Financial Institutions, IT and Their Impact In Improving E-Government**

Technology is faster improving the productivity of all financial institutions, as commercial banks, insurance companies, and other specialized financial institutions (e.g., pension funds, mortgage, and leasing companies, etc.). The major businesses of **commercial banks** include loans (commercial and consumer loans), deposits and financial investment (long term and short term). The **insurance industry** consists of property insurance, health care insurance, life insurance, and other little categorized. As we know, the new innovation in banking such as internet banking does not compare with insurance company.

The nature of heterogeneity of insurance products may cause the insurance industry to be more "brain intensive" than "capital intensive" in the use of information technology. The slow adaptation to the e-finance technology in the insurance industry reflects the fact that transaction, interactions between policyholders and insurers are less frequent in insurances.

There are some strong reasons which explain the independence of all financial institutions from IT:

1. IT improves the profit efficiencies of financial institutions for all countries which insist to follow a model of knowledge based economy;

2. The impact of IT is very significant for commercial bank.

3. There are several policy implications for the commercial banks in Albania, insurance companies, governments, IT vendors, and international organizations.

4. In order to explore how IT improves the performance of financial institutions in Albania, they must adapt some methods and models, or even to apply the multivariate analysis to test whether the financial institutional markets are integrated. There are several statistical methods, discuss their underlying economic theories and explain how to use and explore the productivity of financial institutions. For instance, multivariate analysis (i.e., MANOVA) is used to test the international market integration hypothesis.

5. IT investment improves the efficiency across nations, even though IT managers are not aware of the linkage of IT to the profit generation. The level of improvement it depends by level of development. The time-varying patterns of the effects of IT and COM further signal the upward trend of the IT industries.

### **E- Government and economic development**

E-government means using IT to provide citizens with an improved access to information related to public administrations. In addition to the traditional approach, which sought to meet internal operation needs and solve problems associated with efficiency and costs, e-government focuses on the potential of external interactions and emphasizes the importance that citizens assign to customer service, convenience and user- friendliness (Gonzalez, Gasco and Llopis, 2007). In short, e-government is the application of information technology and e-commerce to the processes of government.

Adoption of IT and the global computer networks for conducting business activities is known as e-business. The phenomenon of e-commerce is simply, the driving force of the new economy where everybody is connected everywhere and anytime. It overcomes the geographical and time constraints and serves as a great equalizer by creating a single competing field for all (small and large firms, experienced and inexperienced, domestic and foreign). In a word, e-business or e-commerce drives globalization.

E-commerce is not just buying and selling of goods and services, but also servicing customers, collaborating with business partners and conducting electronic transactions within an organization (Turban and King, 2003). As e-commerce matures and its tools and applications improve, greater attention is being given to its use to improve the business of public institutions and government (country, state, county and city).

E-government is a vital part of e-commerce. The application of information and communication technology is one of the major prerequisites for increasing efficiency in state administration business operations. Information technology represents the foundation and encourages restructuring of business processes in

state administration. It also provides interactive services on the Internet, that is, creates an electronic public administration.

### **E-Based Economy as a System That Is Based On E-Government and IT**

Economic growth has always been the core problem of international economies, a global issue, which leads many academics to explore the economic growth of knowledge-based economy involving international economic transactions. Constructing such models of economy means first of all to develop based on human capital rather than physical capital. This model needs R&D investment as the driving force for growth, but all this must be done through the paths of Information Technology, because is the sector of IT which implement the model.

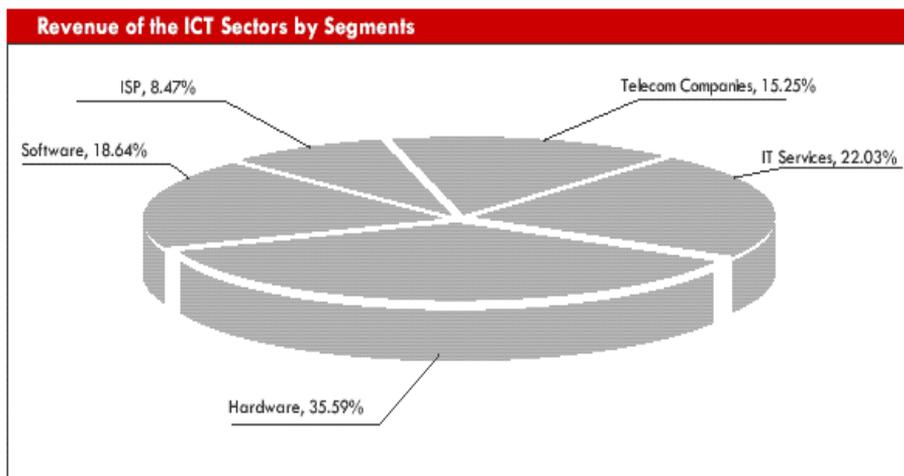
One of the main characteristics of new economy, economy based on the knowledge, is a focus on increasing globalization and expanding IT. We are in the information age. People are often frightened of technological change. Yet the world would be much more frightening without innovation. In traditional growth theory, or growth accounting theory, economies have limited resources of capital and labor. Therefore, without better ways to use these resources, growth would soon run out of steam. Traditional models of growth developed in the 1950s concentrated largely on inputs of capital and labor, and had nothing to say about the technological change. A new growth theory needs knowledge responding to market incentives such as improved profit opportunities or better education. Economic incentives for innovation have strengthened in recent years. Raising finance for innovation has become easier, and a bigger global market has increased the likely return.

Information and technology brings the economy closer to the model of perfect competition, but governments still retain an important role in ensuring that the opportunities offered by IT are fully exploited. IT is very important for each government, for each economy. IT is necessary important for government to do all basic things, because it increases the rewards for doing so. For example, open markets help to speed up technology transfer, and education increases a country's ability to absorb knowledge. One economic important rule is that new technology is not a tool which cures every economic ill. To have all the benefits from IT, governments need to pursue sound policies.

### **3. BACKGROUND INFORMATION ON THE ALBANIAN MINISTRY OF FINANCE TREASURY SYSTEM - CASE DESCRIPTION**

Research in ICT in Albania has not been a main focus. The ICT sector in Albania has had considerable growth during the last years. It is notable to mention the number of ICT companies created and active in the last five years. In the last three years, the liberalization of the telecommunication market has been followed by the foundation of several telecom operators. The following chart provides an overview of the revenue of ICT Sector by Segment.

Figure 2: Revenue Of The Albanian ICT Sectors By Segments

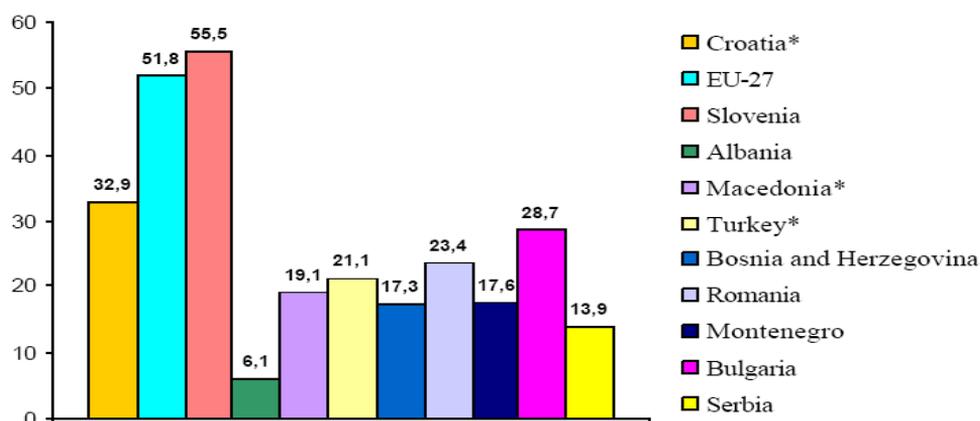


Compared to the world trend, the Albanian economy is characterized with low level of usage IT and the Internet. The companies are insufficiently utilizing the opportunities provided by the contemporary technologies in terms of improving their efficiency and their inclusion in the global information society. The current situation in the country is due to the lack of complete legal framework, international standards, competitive prices of the telecommunication (internet) services in the country, as well as the lack of funds, knowledge, skills, adequate strategy, good management etc. The weak relative position of the IT sector of the Republic of Macedonia reflects the poor development of the country's economy and a low overall purchasing power.

According to the Internet World Stats in comparison to the other countries from the Balkan region as well as countries with EU candidate status, Croatia is very high on the scale with 32.9%, and Albania is at the end of the scale with minimal 6.1%.

The Internet in Albania is mostly used for the some purposes, as internet user, were using Internet for communication (receiving/sending e-mails and communication like Chat, MSN, telephoning), searching information and requesting on-net services and for playing or downloading games, pictures, music; Internet for training and education (i.e. for acquiring knowledge, consultancies, training/courses offered or following online courses) ; e-government for finding information, downloading official forms or sending filled in forms; e-banking or offered/ sold goods/services via Internet; Persons that used the Internet ordered/bought goods or services online for private purpose.

Figure 3: Internet Penetration In Selected Countries (In %), 2007



This case is focused on treasure system of Albanian Ministry of Finance. What is moving the world is related to the fact that E-finance is helping the international economies in the process of globalization and specifically in the proces of european integration. This is done through ministries of economies, ministries of finance of finance agencies. This is exactly the focus of our paper, to show how national financial bodies, as Albanian Ministry of Finance is helping not only the globalization, moving thurgh an e-based economy, but also in the process in european integration.

The Government of the Republic of Albania considers the development of the information society and the use and deployment of ICT in the country as one of the highest priorities in achieving higher living standards and economic growth. ICT should be used to create employment, to improve working conditions, and to motivate highly educated individuals to remain in the country. National and local needs will be important factors to be considered during the development of the Information Society in Albania.

Albania has been undergoing radical changes and transitions since the dissolution of communism at the beginning of the 1990s. Although still comparatively isolated from international cooperative initiatives and lacking adequate institutions and support structures, the main actors carrying out research and development projects are the Academy of Sciences and higher education institutions. Higher education and science are mostly treated separately, and PhD programmers are often disorganized. Further progress in the reorganization of research institutes, the creation of national research centers, the introduction of standards and performance indicators, and the improvement of the infrastructure and legal framework are absolutely necessary.

Scientific research activities in Albania *are very limited*, primarily due to the lack of infrastructure and the insufficiency of financial resources. A considerable number of qualified specialists have left scientific research institutions and most of them

have emigrated abroad. Specialized ICT departments in particular have suffered considerably from the “brain drain.” For the same reason, public institutions encounter major difficulties to find the specialists necessary for the daily maintenance of ICT infrastructure and systems. The academic community has been ignored and, as a result, has not been involved in important ICT projects. This not only penalizes such projects by not involving independent specialists from academic circles, but it also penalizes specialists themselves by driving them toward emigration. ICT specialists are demotivated by low salaries, which undermine the entire public scientific research work system in Albania. This leads to serious, albeit hidden, consequences for the system of scientific research institutions, bearing long-term negative effects.

The Albanian National ICT Strategy was created from a project co-financed by the Open Society Institute, the UN Department of Economic and Social Affairs, and UNDP Albania. All the documents prepared by national or local bodies' aims to introduce and clarify impact that IT has on government, business or financial systems. These documents describe the general goals and define a number of strategic actions that serve to achieve these general goals. For this purpose, the strategy is subdivided into five parts, and fourteen individual goals. The parts describe the major strategic areas to be addressed, and are directed to different target groups in the country:

1. **Part I:** Government as Promoter, Legislator and User of ICT, is directed at the government, and addresses the needs for suitable ICT institutional structures, policy definitions and introduction of e-government services.

2. **Part II:** Use of ICT for Education, Research, Health and Social Services, aims at deploying ICT for the direct benefit of citizens.

3. **Part III:** Building Infrastructure needed for an Open Information Society, addresses the need to deliver the infrastructure necessary for the information society.

4. **Part IV:** Generating Economic Growth in the Private Sector addresses the need to promote the private sector to embrace the tools of the information society.

5. **Part V:** Ensuring Relevance of ICT Strategy within a Regional and European Context focuses on the need to ensure ICT policy cooperation on a supranational level.

Table 1: Some part of Albanian Strategy for IT' development

Section	Goals
I. Government as Promoter, Legislator and User of ICT	1. Pro-Active, Well-Coordinated National ICT Policies 2. Creation of ICT-Supportive Legislative Environment
	3. More effective, transparent, responsive government and public services: <ul style="list-style-type: none"> <li>• Sub-goal 3.1: E-government services of government institutions at central level</li> <li>• Sub-goal 3.2: E-government services of administrations at regional and local levels</li> </ul>
II. Use of ICT for Education, Research, Health and Social Services	4. Promoting basic computer literacy – ICT Education for all.
	5. Creating a cadre of advanced ICT specialists – Education and Research in the ICT Domain.
	6. ICT in Health and Social Services
	7. Supporting development of locally relevant content and applications
III. Building Infrastructure needed for an Open Information Society	8. Creation of a competitive, liberalized telecommunications sector.
	9. Development of inexpensive, fast and secure ICT infrastructure throughout Albania.
IV. Accelerating Economic Growth in the Private Sector	10. Development of the ICT Sector as a Production Sector.
	11. Supporting Electronic Business.
V. Ensuring Relevance of ICT Strategy within a Regional and European Context	12. Active participation in SEE regional Initiatives.
	13. Active participation in EU Initiatives.
	14. Monitoring of Albanian ICT Developments in Regional and European Context.

*This table describes the sections and the key goals of the Albanian National Information and Communication Technology Policy*

### Features Of Albanian Treasury System

The Implementation of the Treasury System has adopted a comprehensive policy reform programme to strengthen Albania's institutional and governance capacity. A major element of this programme involves strengthening of the Ministry of Finance, including its public expenditure management functions (budget formulation and execution, macroeconomic forecasting/modelling, treasury and cash management, accounting and internal auditing), its revenue administration functions (in particular Tax and Customs), and strengthening of its own internal management capacities.

The primary objective of the project for strengthening Albania's Treasury functions is to contribute to the twin goals of improving governance and institution building. When fully implemented, it will achieve this by providing the ability to capture and process all government financial transactions - both payments and revenue collection - at source (or as close to source as possible) and to enable these to be managed in accordance with budgets and spending authorities. It will also enable up to date and accurate information to be available for fiscal and liquidity management.

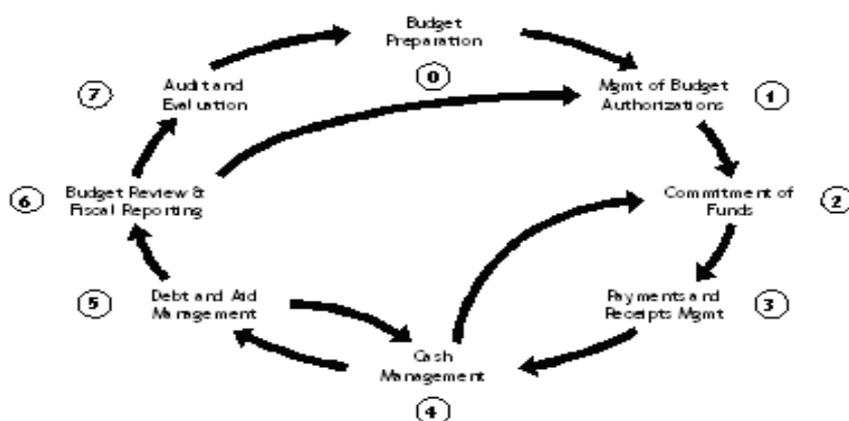
The broad benefits are expected to be delivered by successful implementation of a comprehensive Treasury system, as full integration of budget and budget execution data, thereby allowing greater financial control; Better planning for cash as well as close and timely monitoring of the government's cash position; Adequate management reporting at various levels of budget execution; Better data quality for the preparation and execution of the budget; Easier preparation of financial statements and other financial reports for budgeting, analysis and financial control.

We conclude that the establishment of an effective Treasury system will contribute directly to improving the transparency and accountability of government and to meeting the requirements of *Code of Good Practice on Fiscal Transparency—Declaration on Principles*. Also, by providing both a timely, detailed, comprehensive flow of relevant data and the tools for managers throughout government to analyze those data, the system will make a powerful contribution to the development of a "professional, merit-based, depoliticized civil service". Finally, the establishment of an effective Treasury system will contribute directly to improving the transparency and accountability of government and to meeting the requirements on Fiscal Transparency-Declaration on Principles.

The Albanian Financial Management System is designed to provide support for all public finance operations, collect accurate, timely, complete, reliable and consistent information on all financial events, and provide adequate management reporting, and support government-wide and agency policy decisions. The Public Sector Reform Strategy identifies seven major components and specific objectives to be achieved under each of these, on the basis of which an implementation plan has been prepared. Some components of the Strategy strongly focus on establishing rule of law and building trust in Government through building its capacity to put appropriate legal and regulatory frameworks in place, enforce these laws, and increase accountability.

The Public Financial Management System is designed to provide support for all public finance operations, collect accurate, timely, complete, reliable and consistent information on all financial events, provide adequate management reporting, support government-wide and agency policy decisions, Provide complete audit trail / auditable financial statements.

Figure 3 : Public Financial Management Cycle



This figure shows how is designed the Albanian Public Financial Management System, which are the main part and functionality of the system.

Related the AMoFTS Business Flows the AMoFTS functional processes are classified as:

Budgeting

- Preparation of Estimates, Consolidation and Approval
- Appropriation, Budget Breakdown and Budget Releases

Procurement and Payment Management

- Commitments and Purchase Orders, Expenditure Requests
- Payment Execution

Revenue and Cash Management

- Revenue Accruals, Revenue Reconciliation and Distribution
- Bank Statement Reconciliation, Cash Forecasting

Fixed Asset Management

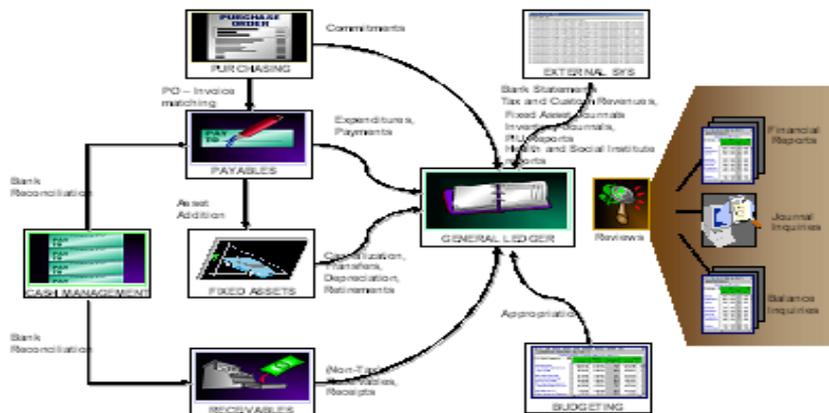
- Off-line FA management, FA journaling
- On-line FA management, Asset Additions, Asset Transactions and

Depreciation

Accounting and Financial Reporting

- General Ledger Accounting and Reconciliation, Period Closing
- Fiscal Reporting

Figure 4: AMoFTS System Architecture

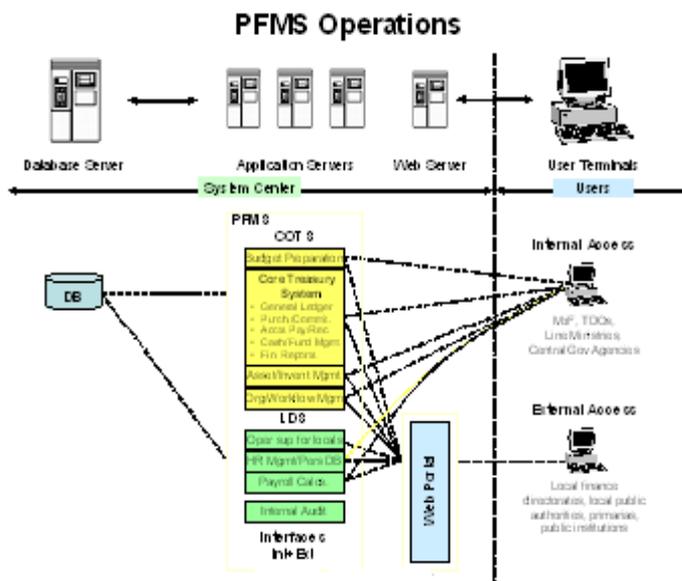


*This figures show the clasified of AMoFTS Business Flows the AMoFTS functional processes.*

Application process needs monitor systems which will look for design phase, procurement phase, system integration and implementation. The first phase start with development of application software, supporting the central servers and field hardware, with technical support systems, and finalizing the system safety or security and business solutions, and finalizing with web publishing or web portal. The main operations are shown in the following (fig.4):

Design and Implementation of Information Systems includes Secure countrywide Network infrastructure; Development of Application Software; Central Servers and field Hardware; System and network management; Technical support systems; System safety / security and business continuity solutions; Web publishing (web portal).

Figure 5: The Operations Of The Procurement System



Understanding the importance of being a part of the global (information) society, all segments banking, insurance companies, government, etc), in the Albanian society are involved in the adoption of IT in their operating as well as everyday activities. Although the figures show low level, the raising trend is what worth fostering and supporting with different projects and activities. With its aspiration to become an EU member country Albania needs to adhere to the “...strategic goal: to become a dynamic and competitive knowledge based economy in the region...”

### Concluding comments

This article was focused on the fact that technology is faster improving the productivity of all financial institutions, as commercial banks, insurance companies, and other specialized financial institutions (e.g, pension funds, mortgage, and leasing companies, etc.). The analyze is done through a case study which is focus of our paper, to show how national financial bodies, as Albanian Ministry of Finance is helping not only the globalization, moving thurgh an e-based economy, but also in the process in european integration.

Macroeconomic indicators show a *positive growth rate* for Albania in recent years. While performance has been impressive, however, there are concerns regarding the sustainability of high rates of economic growth. In particular, the Albanian government should note with caution important changes in the distribution of GDP according to economic activity. The government should allocate a greater share for

**investments in infrastructure**, especially in the sectors of education, health and the environment. Improvement in these areas will serve to increase the quality of human capital by improving life expectancies, living conditions and skill levels.

The private sector's investment level in IT in Albania is still low. SMEs, or rather micro-enterprises (entities with fewer than five employees), make up the vast majority of private businesses. Their survival strategy focuses on labor intensive, low-cost production. Against this background, IT falls almost entirely under public responsibility. Overall, there are very few private institutions, and these few operate mostly in the field of Human, Social and Political sciences but their personnel structures and their financial and cooperation procedures are not stable. However, in the field of information technology, the private sector became dominant by establishing market activities with some relevance to research and development.

Several small companies operating in the IT area were established thanks to local initiatives and are run by Albanian engineers specializing in IT. The majority of products are imported from abroad. However, there is a strong tendency and increase in the IT sector to **adapt products to local needs**, such as being adapted to the local language. There are a variety of choices with regard to equipment and programs, which are accessible and affordable for the majority of small and medium enterprises as well as for many individuals. The average annual investment in IT is about more than 2.5-3 million USD (or 2.2 million Euro) and all IT revenues total about 20 million USD (or 15 million Euro).

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**FISCAL POLICY DURING THE CURRENT CRISIS**

*Cristina Aurora Bunea-Bontas and Mihaela Cosmina Petre\**

**Abstract**

*Fiscal policy is an important government tool for managing the economy, having the ability to affect the total amount of output produced - GDP. Changes in the instruments of fiscal policy have impact on aggregate demand, the pattern of resource allocation, and the distribution of income. The article shows the mechanisms through which fiscal policy stabilizes the business cycle, and the specific requirements for fiscal policy during recession; the practical problems that may occur in implementing an effective fiscal policy are also emphasized. In the specific circumstances of the current financial crisis, the revival of the fiscal policy as a macroeconomic policy faces high expectations as to what it can accomplish. Therefore, the paper highlights the composition of fiscal stimulus package, and reviews the specific fiscal stimulus plans adopted so far by different countries and their objectives. The final section examines the fiscal measures implemented by the Romanian government, as a response to the current crisis. The conclusion is that Romania has conducted an inconsistent and ineffective fiscal policy, which has contributed to macroeconomic imbalances and to an increased fiscal pressure on business. Therefore, a medium-term fiscal framework has to be implemented, in order to ensure fiscal effectiveness and sustainability.*

**Keywords:** fiscal policy, automatic stabilizers, discretionary fiscal policy, fiscal stimulus, A European Economic Recovery Plan, Romanian fiscal policy

**JEL Classification:** E62, E63, E65

*“The time to act is now”*

José Manuel Durão Barroso, 2008

**1. Introduction**

Fiscal policy is defined as the deliberate manipulation of government income and expenditure, so that to achieve economic and social objectives, and sustain growth [article on <http://www.buythemap.com>]. Fiscal policy is based on the theories of British economist John Maynard Keynes. Also known as *Keynesian economics*, this theory basically states that governments can influence macroeconomic productivity levels by increasing or decreasing tax levels and public spending. The

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two main instruments of fiscal policy are *government spending* and *taxation*. Changes in their level and composition may have impact on aggregate demand and the level of economic activity, the pattern of resource allocation, and the distribution of income [article on <http://en.wikipedia.org>]. Higher government spending or a decrease in taxes is an injection of income increasing aggregate demand, whilst a decrease in spending or a rising of taxes is an income leakage causing aggregate demand to fall. Based on the Keynesian theory, the level of spending in the economy will determine the levels of output, i.e. Gross Domestic Product (GDP), and employment, hence the government can control these areas of the economy, as it has the power to change aggregate demand, and lessen the fluctuations of the business cycle.

## 2. Specific instruments of fiscal policy

Fiscal policy is an important tool for managing the economy having the ability to affect the total amount of output produced, which is GDP. Its ability to affect output by affecting aggregate demand makes it a potential tool for economic stabilization. The basics of the fiscal mechanism is explained by Weil (2008): *if the economy is in recession*, with unused productive capacity and unemployed workers, then increases in demand will lead mostly to more output without changing the price level; *if the economy is at full employment*, by contrast, a fiscal expansion will have more effect on prices and less impact on total output.

Governments have available various instruments to promote their main objectives, like as allocation of resources, stabilisation of the economy, redistribution of income, and economic growth. It must be realised that, at times, while the instruments have changed, the main governmental objectives have remained the four listed above [Tanzi, (2008)].

**Government spending** is the most traditional instrument. Both the level of public spending and its structure or composition are important and can be considered as separate instruments. **Taxation** is the other obvious instrument, which comprises at least four potential and separable instruments, such as the level of taxation, the structure of taxation, tax expenditures and tax incentives. According to Tanzi, some countries rely more on levels and structures (Scandinavian countries) while others have relied more on tax expenditures (Anglo-Saxon countries) and on tax incentives (Asian countries and many developing countries) (see Tanzi (2008) for an overview of fiscal policy instruments).

Fiscal policy can work in two general ways to stabilize the business cycle, which are **automatic stabilizers**, and the **discretionary fiscal policy**.

**Automatic Stabilizers** consist in a “built-in” fiscal mechanism that acts to reduce automatically the expansions and contractions of the business cycle [fiscal policy, article on <http://www.amosweb.com>]. This mechanism expands automatically the fiscal policy during recessions and contracts it during booms, being one form of countercyclical fiscal policy [Weil, (2008)]. It depends on the level of aggregate production and income, such that business cycle instability is automatically

dampened without the need for discretionary policy action.

Automatic stabilizers work automatically, being no need for enacting legislation, passing bills, or undertaking any other policy action. These stabilizers are built into the structure of the economy and the government sets up the rules and criteria under which taxes and transfer payments work. If people meet the criteria, then they pay the taxes or receive the transfer payments. The amount of each depends on the number of people meeting the criteria, which is dependent on business cycle activity [fiscal policy, article on <http://www.amosweb.com>]. Automatic stabilizers increase budget deficits during times of recessions or decrease them during booms. They enact countercyclical policy without the lags associated with legislative policy changes [article on <http://www.investopedia.com>]. They include **income taxes** and **transfer payments**.

▪ **Income taxes** largely depend on the level of aggregate production and income. If production and income rise, tax collections also rise. Income taxes also tend to be progressive, i.e. the proportion of taxes paid increases with income. This means that tax revenue is higher in an economic boom and lower in a recession, not only in absolute terms, but also as a proportion of national income [automatic stabilizers, article on <http://www.amosweb.com>]. Forms of tax that act like automatic stabilizers are: (i) *Taxes on corporate profits* - go up substantially during boom times, and decline rapidly during times of recession; (ii) *Progressive income taxes* - push people into higher income tax brackets during booms, substantially increasing their tax bill and reducing government budget deficits (or increasing government surpluses). During recessions, many individuals fall into lower tax brackets or have no income tax liability. This increases the size of the government budget deficit (or reduces the surplus). Other forms of tax do not exhibit these effects, because they are roughly proportionate to income (e.g. value added tax), or they bear no relation to income (e.g. property tax) [article on <http://www.investopedia.com>].

▪ **Transfer Payments**, including social security to the elderly, unemployment compensation to the unemployed, and welfare to the poor, depend on the level of aggregate production and income. They work opposite to taxes: if aggregate income rises, transfer payments tend to fall, as people are less likely to retire, be unemployed, or fall into the ranks of the poor.

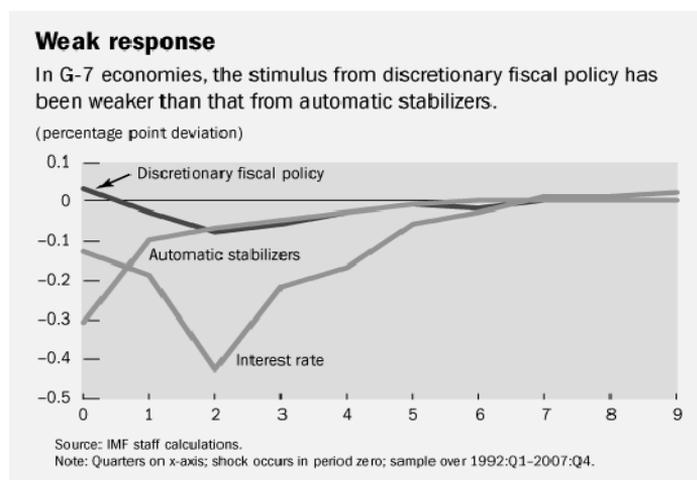
**Discretionary Fiscal Policy** is a policy action consisting of changes in a fiscal program initiated by the government in order to change aggregate demand, providing an alternative way to stimulate the economy when aggregate demand and interest rates are low and when prices are falling or may soon be falling [Feldstein, (2002)]. Discretionary fiscal policy is made more difficult due to lags in recognizing the need for changed fiscal policy and the lags that occur with enacting the changed fiscal policy. There usually is a lag between the time that changes of fiscal policy are needed and the time that the need to act is widely recognized. Additionally, a time lag may be between the moment of recognition and the moment that fiscal policy changes are actually enacted. Lastly, the impact of a change in fiscal policy may not be felt until six to twelve months after the change has occurred. For example, an expansionary fiscal policy may be enacted when the economy is already recovering

from a recession [article on <http://www.investopedia.com>]. An *expansionary fiscal policy* (government spending higher than tax revenue) is a stance of fiscal policy that involves a net increase in government spending, through a rise in government spending or a fall in taxation revenue or a combination of the two, being associated with a budget deficit [article on <http://en.wikipedia.org>]. This leads to a larger budget deficit or a smaller budget surplus than the government previously had, or a deficit if the government previously had a balanced budget. According to Weil (2008), in a recession, the government can run an expansionary fiscal policy, thus helping to restore output to its normal level and to put unemployed workers back to work. Often, the focus is not on the level of the deficit, but on the change in the deficit. A *contractionary fiscal policy* (government spending higher lower than tax revenue) occurs when net government spending is reduced through either higher taxation revenue or reduced government spending or a combination of the two, being associated with a surplus [article on <http://en.wikipedia.org>].

In practice, discretionary fiscal measures are typically slower to arrive than both automatic stabilizers and monetary policy responses. Moreover, fiscal measures often become permanent, implying that public debt moves upward. According to Scott (2008), one of the first questions that policymakers need to address is “whether discretionary fiscal policy can be delivered on time and delivered well”.

He concludes that, in the past, it has usually proven a challenge to meet these criteria: discretionary fiscal policy has usually been used less frequently than monetary policy during downturns, and it has taken longer to arrive, often after it is needed. Scott also notes that the response of discretionary fiscal policy is typically weaker than the stimulus provided by automatic stabilizers (figure no.1).

**Figure no.1 Responses to business cycle changes**



Source: “Policy Responses to Slowdowns: Making Fiscal Stimulus Effective during Downturns” (Scott, IMF Survey Magazine, 2008).

Considering the differences between advanced and emerging economies, an IMF survey (2008) finds that in advanced economies, discretionary fiscal policy has typically been countercyclical, that is taxes have been cut and spending increased during downturns. In emerging economies, discretionary fiscal policy has been procyclical that is stimulus has been added during good times and removed during downturns. This suggests that governments could try to enhance the scope and effectiveness of automatic stabilizers. In a report concerning economic crises in Europe, the European Commission notes that government investment yields a somewhat larger GDP multiplier than purchases of goods and services. An increase in government transfers has a smaller multiplier, as it goes along with negative labour supply incentives. According European Commission's findings, temporary reductions in value added and labour taxes show smaller multipliers. Tighter credit constraints tend to increase the multiplier of these measures. A temporary reduction in consumption taxes is more effective than a reduction in labour taxes; it is attractive from a credibility point of view, since the private sector is likely to believe in a reversal of a temporary tax cut more than into a reversing of a temporary spending increase. Permanent reductions in VAT or labour taxes could yield short-run effects exceeding those of a permanent expenditure increase, because they reduce distortions imposed by the tax system [European Commission, (2009b)].

### 3. Fiscal Policy during the current financial and economic crisis

Economic growth is one of the main aims of macroeconomists and the government, as it allows a movement towards a better standard of living for the population. A recession is negative growth of GDP causing a downswing in the economies' business cycle. This is a direct threat to the primary aims of a government and so is high on its agenda of policies, tackling it being a necessity [article on <http://www.buythemap.com>]. If the economy is in recession then a government's priority will be to stimulate growth, by creating more employment and increasing aggregate demand. **Keynesian economics** suggests that adjusting government spending and tax rates are the best ways to stimulate aggregate demand. This can be used in times of recession or low economic activity as an essential tool in providing the framework for strong economic growth and working toward full employment. In theory, these deficits would be paid for by an expanded economy during the boom that would follow [article on <http://en.wikipedia.org>]. **Keynes opponents** aver that taxes may be a necessary "evil" to finance government operations and public services, but they distort incentives, reduce investment and labour supply and dampen growth. As for short-term stabilisation, discretionary fiscal spending is too susceptible to political interference. Better to rely on automatic stabilisers that are beyond the reach of politicians' personal interests and to use interest rates and the money supply to influence prices or unemployment levels [Dayton-Johnson, (2008)]. Therefore, in a deep crises, automatic stabilisers may need to be strengthened [European Commission, (2009b)].

In theory, fiscal policy is effective. However, there are practical problems that would affect policy making in a recession. We point out the most important ones:

- Higher government spending can lead to higher interest rates due to all the borrowing that is going on which would cause a discouragement in private sector investment.

- When tax is lowered, although consumers have more money to spend, they will save more due to the fear of unemployment; increasing the amount of jobs does not create this attitude, and so more is spent.

- The scale and logistics can make it inflexible and hard to implement, as a lot of government spending is contractual and cannot be simply stopped and started easily.

Accordingly, the case for using discretionary fiscal policy to stabilize business cycles is further weakened by another tool, the **monetary policy**, far more agile than fiscal policy [Weil, (2008)]. As an alternative, monetary policy controls the supply of money and inflation, and it can be manipulated day to day. However, as a recession puts the government in a difficult position, both fiscal and monetary policy has to struggle to combat the effects of a downturn in economic growth. Fiscal policy is only one way of controlling the economy, if it is used in the correct way and, along with monetary policy, it can be an effective way of keeping growth buoyant [article on <http://www.buythemap.com>].

In the current financial crisis, governments around the world must formulate and implement policies for taxation and public spending. Due to their major impacts on economic growth, income distribution, and poverty, nowadays they tend to be at the centre of economic and political debates [The World Bank, (2007)]. The same opinion is expressed by Dayton-Johnson (2008) who emphasize that one of the unexpected by-products of the current global financial crisis is that “it has placed fiscal policy back at the centre of the public policy debate”. Fiscal systems can provide the resources needed to carry out pro-growth investments and structural transformations, which in developing and emerging economies are so essential for long-term growth. Moreover, taxes and public spending can directly attack poverty and inequality, twin problems that continue to beset the region [Dayton-Johnson, (2008)]. Terrones et al (2009) also emphasize that, during recessions associated with financial crises, fiscal policy tends to have a more significant impact, being more effective when economic agents face tighter liquidity constraints.

As a response to the financial crisis, monetary policy has been radically eased, in terms of significant interest rate reductions [Andersen, (2009)]. Olivier Blanchard, IMF Economic Counselor, and Carlo Cottarelli, Director of the Fiscal Affairs Department within IMF [interviewed by Andersen, (2008)] expressed the opinion that in the current financial context, the room for further monetary easing is shrinking, as in some countries policy interest rates are approaching zero. The same opinion has Andersen (2009), according to whom interest rates have been reduced to low levels, implying that the room for further interest rate reductions is small. Accordingly, it is a widespread perception that monetary policy cannot deliver

sufficient stabilization in the present situation [Andersen, (2009)], an opinion that is constantly brought forth since the collapse of Lehman Brothers [Belke, (2009)].

Corsetti and Muller (2008) underline the necessity of the financing mix (taxes vs. future spending cuts), as well as coordinated cross-border fiscal expansionary policy. The opinion of a common and coordinated fiscal policy implementation is not commonly shared. For example, Belke (2009) suggests that it might be better to have independent national fiscal policies that are not coordinated or not correlated under Economic and Monetary Union (EMU), based on several arguments: (i) fiscal policy can be a source of shocks in the context of the current crisis; (ii) policy makers do not have full control over the outcome, therefore the effect of a certain measure is quite different from what is anticipated; and (iii) the economic forecasts underlying fiscal policy might turn out to be wrong.

Many researchers have the opinion that the global financial crisis is now turning into a worldwide economic crisis [Andersen, (2009)]. This opinion is argued by the continuously revised downwards of business cycle forecasts. Negative growth rates are expected for many OECD countries for 2009. More specifically, overall deficits are projected to increase by 5.5 percentage points of GDP in 2009 and 2010, with respect to both 2007 pre-crisis levels and excluding losses from financial sector support. In advanced G20 economies, fiscal deficits in 2009-2010 are now estimated to be larger, in some cases reflecting weaker growth prospects in 2009 before a stronger recovery in 2010. By contrast, changes in fiscal balances are now expected to be smaller in other G20 countries, particularly those where commodity revenues are important, according to Horton et al (2009). Growth rates are expected to recover only sluggishly, and, consequently, unemployment rates are soaring in all OECD countries [Andersen, (2009)].

In the Spring Forecast for 2009 issued by European Commission, several factors are mentioned for the sharp increase in the projected general government deficits: (i) the economic downturn is bringing about declining tax revenue and rising social security expenditure, notably unemployment benefits; (ii) exceptional revenue windfalls witnessed in the recent boom period are continuing to reverse, which is reflected in a relatively strong erosion of some tax bases; and (iii) in line with the Commission's **European Economic Recovery Plan** many Member States have adopted significant discretionary fiscal stimulus packages to promote investment and sustain demand in general [European Commission, (2009a)]. The **European Economic Recovery Plan** (EERP) was adopted by the European Commission at the end of November 2008, proposing a coordinated stimulus package to be implemented by the Member States taking into account their particular conditions. EERP has one fundamental principle, which is **solidarity and social justice** - *in times of hardship, action must be geared to help those most in need*. In addition, the Plan has two key pillars:

- **A major injection of purchasing power into the economy**, to boost demand and stimulate confidence: Member States and the EU agreed to an immediate budgetary impulse amounting to € 200 billion (1.5% of GDP), to boost

demand in full respect of the **Stability and Growth Pact**. The **Stability and Growth Pact** (SGP) pertains to the third stage of EMU, which began on 1 January 1999, in order to ensure that the Member States maintain budgetary discipline after the single currency has been introduced. SGP is a rule-based framework for the coordination of national fiscal policies, established to safeguard sound public finances. It consists of a preventive and a dissuasive arm. Regarding the **preventive arm**, Member States have to submit annual stability programmes, showing how they intend to achieve or safeguard sound fiscal positions in the medium term, taking into account the impending budgetary impact of population aging. The **dissuasive part** governs the excessive deficit procedure that is triggered by the deficit breaching the 3% of GDP threshold of the Treaty of Maastricht on European Union [<http://ec.europa.eu>].

▪ A **direct short-term action to reinforce Europe's competitiveness in the long term**, aiming the area of “smart” investments (e.g. energy efficiency, clean technologies, infrastructure) [Commission of the European Communities, (2008)]

According to the EERP, actions should aim *protecting employment* and *promoting entrepreneurship* and they have to be done in the four priority areas of the Lisbon Strategy: **people, business, infrastructure and energy, research and innovation**.

a) **People: *the top priority must be to protect Europe's citizens from the worst effects of the current crisis.***

1. *Launch a major European initiative on employment support* by (i) rapidly reinforcing activation schemes, and (ii) improving the monitoring and matching of skills development and upgrading with existing and anticipated job vacancies, in close cooperation with social partners, public employment services and universities;

2. *Create demand for labour* through (i) reducing employers' social charges on lower incomes to promote the employability of lower skilled workers, and (ii) adopting the proposed directive to make permanent reduced VAT rates for labour-intensive services.

b) **Business: *sufficient and affordable access to finance as a pre-condition for investment, growth and job creation by the private sector.*** In order to reduce administrative burdens on business, promote their cash flow and help more people to become entrepreneurs, the Member States should:

▪ Ensure that starting-up a business anywhere in the EU can be done within three days at zero costs and that formalities for the hiring of the first employee can be fulfilled via a single access point;

▪ Remove the requirement on micro-enterprises to prepare annual accounts and limit the capital requirements of the European private company to one euro;

▪ Ensure that public authorities pay invoices, including to SMEs, for supplies and services within one month to ease liquidity constraints and accept e-invoicing as equivalent to paper invoicing;

▪ Reduce by up to 75% the fees for patent applications and maintenance and halve the costs for an EU trademark.

Following the Commission's guidelines in the EERP, the fiscal stimulus should be well defined and be based on the following principles: (i) it should be timely, temporary, targeted and coordinated at the European level; (ii) it should mix revenue and expenditure instruments; (iii) it should be conducted within the Stability and Growth Pact; and (iv) it should be accompanied by structural reforms that support demand and promote resilience. These principles are particularly relevant given that, at the current juncture, markets tend to react rapidly to concerns related to public finance sustainability with an increase in the risk premium on public debt instruments, even in the euro area context [Banco de Portugal, (2009)]. The role of fiscal stimulus, explained by Blanchard [Andersen, (2008)] is to limit the decline in demand as well as output. If no fiscal stimulus is implemented, then demand may continue to fall and “vicious cycles” may appear, like as deflation and liquidity traps, expectations becoming more and more pessimistic and, as a result, a deeper and deeper recession.

Government support can take various forms, with different implications for gross and net debt. These are summarized below, according to Spilimbergo et al (2009).

***Public spending on goods and services*** – theoretically has a direct demand effect than transfers or tax cuts. Practically, the appropriate increase in public spending is constrained by the need to avoid waste. First, governments should make sure that existing programs are not cut for lack of resources. Governments facing balanced budget rules may be forced to suspend various spending programs (or to raise revenue). Second, spending programs that were delayed, interrupted or rejected for lack of funding or macroeconomic considerations, can be (re)started quickly. A temporary increase in public sector employment associated with some of new programs and policies may be needed.

***Fiscal stimulus aimed at consumers*** need to take into account the present exceptional conditions, specifically: (i) decreases in wealth; (ii) tighter credit constraints, and (iii) high uncertainty. The degree of pass-through to consumers is uncertain, its unwinding can contribute to a further downturn, and it is questionable whether decreases of just a few percentage points are salient enough to lead consumers to shift the timing of their purchases. Possibly larger, but more focused incentives, cash transfers for purchases of specific goods may attract more attention from consumers and have larger effects on demand.

***Fiscal stimulus aimed at firms*** has as a main objective ensuring that firms do not reduce current operations for lack of financing. While this is primarily the job of monetary policy, there is also some scope for governments to support firms that could survive restructuring, but find it difficult to receive the necessary financing from dysfunctional credit markets.

Considering the recommendations of European Commission, it is necessary to answer two important questions: “What is the appropriate fiscal policy in the short term and what does this imply for the fiscal outlook?” and “What are the key elements of a fiscal strategy to ensure fiscal solvency?” [Cottarelli, (2009)].

Answering the first question, Spilimbergo et al (2008) highlight that, under the circumstances that the current crisis will last at least for several more quarters, the fiscal stimulus can rely more on spending measures, as they may have advantages over tax cuts or increases in transfers, which operate by raising the purchasing power of households and firms in the economy, given the highly uncertain response of the latter to an increase of their income in current circumstances.

For ensuring fiscal solvency, two priorities have to be considered to ensure that short-term crises alleviation is aligned with long-run development: (i) strengthening the social safety in order to help the most vulnerable and those most affected by the crisis to cope; and (ii) spending increases should concentrate in areas such as infrastructure that are likely to contribute to growth in the long term [Kraay and Servén, (2008)]. In addition, experience shows that lower direct fiscal costs and higher recovery rates were achieved in the past (taking into account the severity of the crisis) when the banking crisis resolution strategy was (i) implemented swiftly, and transparent and received broad political support; (ii) backed by strong public institutions and legal frameworks; (iii) consistent in terms of fair and uniform treatment of market participants; and (iv) was part of a clear exit strategy, including restructuring of the banking sector [Schaechter, (2009)].

#### 4. Factors that matters in strengthening the reaction to fiscal stimulus

Barrell et al (2009) identify two factors, which may matter for the transmission of fiscal policy impulses:

- **Openness** of a country, measured by import volumes as a share of GDP, plays an important role in evaluation of the effectiveness of fiscal policy. When a government pursues an expansionary fiscal policy, a one-to-one effect on output cannot be expected, as a part of the aggregate demand's growth will go to imports. The larger is the share of imports in a country's GDP the bigger is the leakage to the imports and the less effective is the fiscal package.

- **Liquidity constraints** approximated by the relationship between changes in consumption and changes in real disposable incomes, evaluate the strength of the impact of fiscal policy on domestic demand. Liquidity or borrowing constrained consumers spend more of increase in their current incomes than those who are able to make optimal borrowing and spending plans over time. The greater the share of liquidity constrained agents the larger the effects of fiscal shocks.

When taking into account **the size of the economies of Member States**, the distribution of fiscal stimulus efforts is broadly in line with the distribution of their needs and with the distribution of their ability to implement fiscal stimulus, without running into severe problems with regard of their balance of payments or fiscal position. This conclusion, drawn by the European Commission (2009b), is based on the assumption that the fiscal stimulus packages are indeed temporary and will be fully reversed at the appropriate time when the economy recovers.

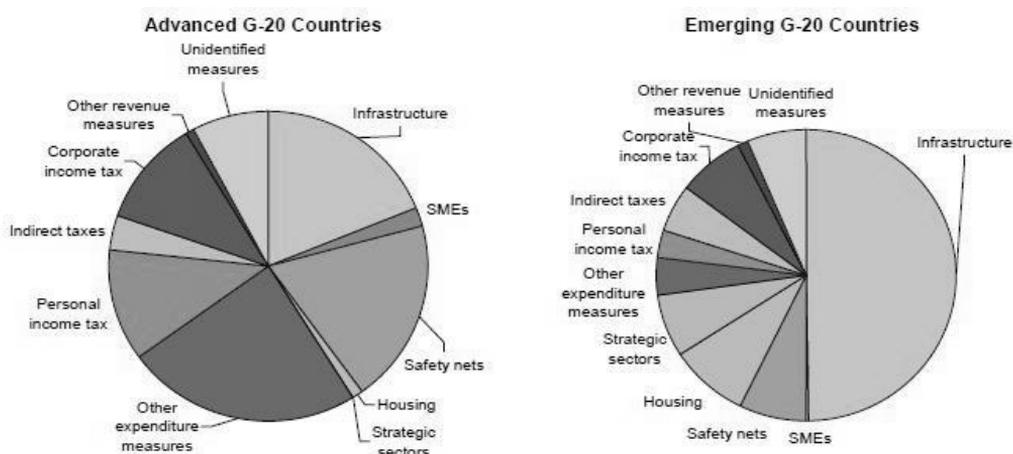
To maximise its impact, the budgetary stimulus should take account **the starting positions of each Member State** and their **fiscal space**. Fiscal space is the room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy. The composite indicator, developed in European Commission, is created including: (i) the general government gross debt-to-GDP ratio, (ii) potential government contingent liabilities to the financial sector, (iii) estimates of foreseeable revenue shortfalls in the medium run, (iv) the current account balance as an indicator of external imbalances, and (v) the share of nondiscretionary expenses as a proxy for the vulnerability of public expenses to meet short-run obligations [Schaechter, (2009)]. According to EERP, “those that took advantage of the good times to achieve more sustainable public finance positions and improve their competitive positions have more room for manoeuvre now”. In countries with high pre-crisis ratios of public sector debt to GDP, lack of fiscal space not only constraints the government's ability to implement countercyclical policies, but also undermines the effectiveness of fiscal stimulus and the quality of fiscal performance [Baldacci et al, (2009)]. In countries with high debt or lower per capita income, crises lasted almost one year longer. Schaechter (2009) appreciates that during the strong economic pre-crisis times EU Member States “did not sufficiently strengthen their state of public finances, often in contradiction with their medium-term plans”.

Actions to alleviate the recession are involving *fiscal costs* no matter they are based on automatic stabilizers or discretionary fiscal stimulus. According to IMF (2009a), some of these impacts will be short-lived and others will be longer lasting or even permanent. As things stand now, the fiscal costs of the financial and economic crisis are expected to be considerable. In its Spring 2009 forecast, the European Commission projected that government borrowing in the euro area would rise to 5.3% of GDP in 2009 and 6.5% in 2010. In the euro area, government debt ratio, which stood at 66% in 2007, is projected to rise to 84% in 2010. Thirteen out of sixteen euro area governments are projected to breach the 3% of GDP deficit reference value of the revised SGP [European Commission, (2009a)] . Moreover, according to González-Páramo (2009), “all are at risk of doing so next year”. These figures reflect the impact on public finances of the contraction in economic activity. They also reflect the costs of discretionary fiscal stimulus measures adopted in many countries. It is worth to mention the IMF's conclusion that the automatic stabilizers' impact is increasing as the economic conditions are weakened [IMF, (2009a)].

Baldacci et al (2009) emphasize that **the composition of fiscal expansions matters for crises length**. Stimulus packages that rely mostly on measures to support government consumption are more effective in shortening the crises duration than those based on public investment. 10% increase in the share of public consumption in the budget, reduces the crises length by three to four months. Many countries have announced fiscal stimulus plans. We summarize them, according to the IMF's Companion Paper (2009a):

▪ **Regarding the composition of fiscal stimulus package: (i) Expenditure measures:** Almost 2/3 of the fiscal stimulus has been represented by expenditure measures with particular emphasis on increased spending for infrastructure. Fifteen of the G20 have announced plans to increase spending on infrastructure, largely on transportation networks (Canada, France, Germany, and Korea, among others), either in the form of direct central government spending, or through capital transfers to local authorities. According to Horton et al (2009), emerging G20 countries have announced somewhat larger stimulus packages for 2009, on average, than advanced G20 countries. This reflects smaller automatic stabilizers and consequently greater need, as well as substantial fiscal space in key emerging market countries. China, Russia, Saudi Arabia, and South Africa have introduced large packages. Emerging market discretionary measures are also more heavily weighted to infrastructure investment and less focused on income tax cuts (figure no.2). **(ii) Revenue measures:** Nine G20 countries have announced sizable cuts in personal income taxes (Brazil, Canada, France, Germany, Indonesia, Japan, Spain, the UK, and the US); while in six, indirect tax cuts have been announced. Cuts in the corporate income tax (CIT) have also been frequent but not as large; these include outright reduction in the CIT rate (Canada, Korea, and Russia), investment incentives (France and Korea), or more favourable depreciation schedules (Germany, Russia, and the US).

**Figure no.2 Group of 20 (G20) economies: Fiscal stimulus by category in 2009**



Source: “*The State of Public Finances: A Cross-Country Fiscal Monitor*” (Horton et al., IMF Staff Position Note SPN/09/21, 2009, pp. 5)

▪ **Regarding the aim of fiscal stimulus package:** Many countries have announced plans to protect vulnerable groups, including by strengthening unemployment benefits (Russia, the UK, and the US), cash transfers to the poor

(Korea) or support to children (Australia, Germany) or pensioners (Australia, Canada). A few G20 countries are also stepping up support for small and medium enterprises (e.g., Korea) and strategic or vulnerable sectors, such as construction (in Germany, for energy efficient buildings and repairs and renovations), defence and agriculture (Russia). Finally, a few countries are using stimulus measures to address longer-term policy challenges, such as improving the quality of health and education (Australia and China) or introducing incentives for environmentally-friendly technologies (China, Germany, and the UK). Revenue measures have targeted primarily households, through cuts in personal income and indirect taxes.

Reviewing the supportive fiscal policies, IMF shows that the fiscal expansion is greater in advanced economies, reflecting the larger size of their governments and the greater role of automatic stabilizers such as income taxes and transfers (welfare payments, unemployment benefits) [IMF, (2009b)]. For the G20 economies, crisis-related discretionary measures are estimated at about 2% of GDP for 2009 and 1.5% of GDP for 2010, both relative to 2007 baselines. The categories of stimulus that were implemented most rapidly - tax breaks and transfer payments - are those that typically have lower effects on activity. Stimulus measures that have higher multipliers will likely be implemented at an accelerated pace during the second half of 2009, reflecting the lags inherent in new and expanded government spending programs, particularly in infrastructure. Estimates for 2010 reflect the phased implementation of stimulus spending initiated during 2009 and a carryover of tax provisions as well as the continued operation of automatic stabilizers.

## **5. Fiscal policy in Romania during the current crisis**

According to the European Commission's Spring Forecast 2009, in Romania in the first three quarters of 2008, domestic demand for both consumption and investment boomed, fuelled by strong wage increases and a rapid expansion of credit. However, it proved that the ones less optimistic concerning the impact of the financial turmoil in the US and advanced Europe were, unfortunately, right. The effects of the turmoil have arrived in Romania with a lag, and the real and financial consequences are such that Romania faces a very sharp and disruptive economic slowdown. The largely foreign financed domestic demand boom and overheating pressures came to a sudden end at the beginning of the fourth quarter of 2008, following the significant tightening of international capital inflows, increased investor risk aversion to home-grown vulnerabilities and decelerating disposable income. Hence, domestic demand contracted by almost 2% y-o-y (year-over-year) in the fourth quarter, compared with an average increase of 14½% y-o-y in the first three quarters [European Commission, (2009a)].

In 2008, the budget deficit surpassed the maximum threshold of 3% of the GDP set by the Stability and Growth Pact, being of 5.4% of GDP (ESA methodology). This was mainly due to substantially higher-than-planned current spending, notably in public wages and social transfers. In addition, overly optimistic

revenue projections did not materialise and a sudden drop in revenue collection in the last two months of the year owing to the economic slowdown added to the worse-than-expected outcome.

These lead us to the conclusion that managing an economic boom has proved difficult: macroeconomic imbalances have widened - due to a persistent excess of consumption and investment over disposable income - and relatively high inflation has come up. Fiscal policy has contributed to the imbalances by more than spending revenues from higher growth (which led to larger fiscal deficits). Unfortunately, Romania has missed the opportunity to create buffers under the continued-boom scenario as a protection against a possible sharp slowdown [Fernández-Ansola and Jaeger, (2008)]. In our opinion, higher revenues from the continued economic boom should have been saved to create room for a fiscal expansion in case that inflows and the economy slow down significantly. A sharp-slowdown scenario has put strong pressure on the fiscal position, in the context that this was already weakened by inconsistency, due to a large number of taxes and their frequent changes, resulting in an increased fiscal pressure on business environment.

The 2009 budget adopted in February 2009, contained several measures to lower the deficit, including a recruitment freeze and the reduction of various bonuses in the public sector, cuts in expenditure for goods and services and subsidies, limiting pension increases to inflation, a 3.3 percentage points rise in the pension contribution rate and a bringing forward of the schedule to increase excise taxes. On the revenue side, measures aimed at eliminating certain tax deductions and allowances (in particular on company cars and depreciation of revaluated assets). On the other hand, the government planned a substantial increase in public investment in 2009 compared with 2008. These measures were reflected in a budget rectification approved by the government in April 2009 [European Commission, (2009a)].

The Business Monitor International's regional report on political risk and macroeconomic prospects, issued in October 2009, argues that the data for Romania showed the economic downturn deepening during the second quarter 2009. According to the National Statistical Institute (NSI), the Romanian economy shrank by 8.8% y-o-y during the second quarter 2009, surpassing the 6.2% decline of the previous quarter, which indicates that economic conditions in Romania have deteriorated comparing to the first quarter. This translates into a poor outlook for tax collection as corporate and household earnings continued to suffer. This is especially pertinent given that unemployment is typically a lagging indicator of the business cycle, with VAT receipts and income tax collection likely to deteriorate even when the economy embarks on recovery. In addition, any expenditure cuts proved unpopular among the electorate, making it increasingly difficult for the government to satisfy the IMF's loan conditions.

Though the IMF has raised Romania's budget deficit target in 2009 to 7.3% of GDP (from a previous 4.6%), the government is still struggling to stabilise the fiscal account. Finance Minister Gheorghe Pogea announced in August that the government would slash RON5.5bn from public expenditures in 2009. Initiatives

include sending public sector workers on unpaid holiday for 10 days (contrary to the European Commission's recommendations), eliminating overtime pay, as well as reducing spending on goods and services. While tightening fiscal policy has sustained foreign investor risk sentiment, the risks to political stability has raised as unemployment increased and real incomes fall alongside the reduction in public sector pay. There is still likely that the required deficit target to be exceeded. The Business Monitor International's regional report issued in November 2009 forecasts a shortfall equivalent to 8.0% of GDP in 2009. The planned reduction in public expenditures is likely to prove insufficient to contain the gaping fiscal shortfall, given the extent to which Romania's economic downturn is unfolding.

Under these circumstances, according to the CESifo World Economic Survey published in August 2009, the assessment of the volume and structure of Romanian policy measures to fight financial and economic crisis was 1.3 (WES scale: 9 – fully sufficient; 5 – more or less sufficient; 1 – not sufficient) [Stangl and Nerb, (2009)].

Regarding the fiscal measures, our opinion is that they put more pressure on people and business, contrary to the recommendation of European Commission to “*protect employment and promote entrepreneurship*”. Few examples are presented below:

- introducing the minimum tax on profit, which, instead of increasing the public revenues, has led to self-liquidation of small firms, increased unemployment, and reduced private initiative;
- large delays on VAT refund on behalf of public authorities, for exporting companies, which result in lack of liquidity;
- maintaining the requirement to prepare the half-year financial statements for all companies; moreover, in some counties, fiscal authorities imposed that these statements to be audited by an accounting expert (which is not a legal-based requirement); this result in an increased cash burden for the SMEs;
- increasing the social charges, referring to the contribution to social security, which is higher with 1% for employees and 2.3% for companies;
- sending public sector workers on unpaid holiday for 8 days, which is completely against the European Commission's recommendation, contained in the EERP: “*the top priority must be to protect Europe's citizens from the worst effects of the financial crisis*”.

Therefore, in the current economic context, Romania's first priority should be to tackle macroeconomic and fiscal imbalances that pose risks to the sustainability of its medium to long-term growth path. In order to increase external competitiveness and to lower the current account deficit and inflation, Romania has to implement a medium-term fiscal framework [Ernst & Young, (2009)], in order to ensure fiscal sustainability. It is also necessary to revise the composition of expenditure to increase the share of growth-enhancing spending by reducing and redirecting state aid to horizontal objectives and to keep wage developments in line with productivity growth. In the context of a coherent better regulation policy, the implementation of measures to substantially reduce administrative procedures and delays in obtaining authorizations has to be done urgently, in order to improve the business environment

and reduce sources for corruption. These will help ensure the European Economic Recovery Plan is implemented in a way that is compliant to long term sustainability as well as responds to the economic crisis.

## 6. Conclusion

Crises can have long-term negative effects, damaging human and physical capital with negative implications for productivity and potential output growth. Therefore, early recovery from a crises is important, to minimize output losses in the short term and enhance medium-term growth prospects. We subscribe the opinion that this calls for timely, targeted and well-designed fiscal responses during downturns.

According to our findings, the impact of fiscal policy on demand depends on the size of fiscal multipliers, the credibility of the sustainability of fiscal stimulus, the uncertainty surrounding the current and future economic environment, and the intensity and effectiveness of international cooperation. Our conclusion is that fiscal responses may not be effective when initial fiscal conditions are poor and fiscal space is limited. High public debt levels and past macroeconomic instability limit the scope for countercyclical deficit expansions and hamper the effectiveness of fiscal stimulus measures as markets perceive the higher future fiscal risks entailed by larger deficits [Baldacci et al, (2009)].

In Romania, the policy measures to fight financial and economic crisis were assessed as “not sufficient”. We argue that fiscal measures taken so far are ineffective, resulting in increased tax burden for business and people, increased liquidity constraints, and lack of private initiative. These measures aim especially to lower the budgetary deficit, and not to stimulate economic growth. Moreover, these measures are not compliant with the recommendations of European Commission and the EERP provisions. Our conclusion is that, on short-term, Romania should implement a consistent fiscal stimulus package, in order to protect employment and promote entrepreneurship. On medium-term, the fiscal policy objectives should be the implementation of a fiscal framework and an adequate taxation structure, aiming the tax collection improvement and preventing the tax evasion. These will reduce macroeconomic imbalances and ensure fiscal sustainability.

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## QUALITATIVE ASSESMENT OF ECONOMIC EFFECTS OF INTEGRATION IN EU: THE CASE OF ALBANIA

Besa Shahini\*

### Abstract

Everybody is conscious for the importance of Albanian integration in EU. But each of us must be aware of the fact, that this outstanding process is accompanied by some benefits and costs, which has to be paid by our society.

The main objective of this study is to qualitatively asses the economic impact of Albanian integration in EU.

The first section is dedicated to theoretically explanation of the types of effects of integration which may be: direct or directs ones, micro or macroeconomic effects, and short run or long run effects.

In the second part I am mainly focused on a qualitative assessment of effects of Albanian economic integration in EU. The main benefits relate to the new opportunities that will be ushered in, principally arising from better access of Albanian exports to foreign markets, enhanced competitive structures and improvements in efficiency, which in the long run will strengthen the Albanian economy. The costs arise mostly from the change-over from a protected economy to an open competitive one, which could lead to a loss of income and employment..

There are introduced in the third part, three main quantitative methods which are recommended to be used for a further step of quantifying the economic effects of Albanian integration in EU.

**Keywords:** Integration, Effects; Assessment, Qualitative, Quantitative

**JEL Classification:** P51, F20, O19, B41

### Introduction

Integration is one of the words most used and in fashion for the Albanians social and economical life. Politicians, artists, intellectuals talk about political, economical, European, cultural, even spiritual integration. This word is used so much effort that there has been very much efforts to define or understand it by the general public beyond the vague idea that integration is something good, especially the west. Thus, one of the issues on which all agree is that in Albania: *EU membership remains a key objective perspective of Albania.*

Since the beginning of the transition process, the EU is virtually present in every aspect of Albanian life: through election observation, provision of economic aid and by participating actively in the construction and improvement of institutions.

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European integration is seen as a stable and lasting solution of major problems of economic and social development of the country. Against this background, the Stabilization and Association Agreement is in the spotlight of the press and a primary goal of all Albanian politics.

To precisely evaluate the opinion and expectations of some groups in terms of EU integration of their knowledge in this area, it was initiated in 2008 a survey. The survey was focused on groups of Business Administration, Media and Non-Governmental Organizations. The main reason, why only these groups were selected is that they are directly involved and to some extent responsible for Albania's integration into the EU; at the same time they will be more significantly affected by Albania's EU membership.

The survey confirmed the great desire and will of the Albanian society for EU membership. Almost 100% of respondents stated that they were willing to vote pro-integration in a possible referendum on the issue.

In certain groups of Albanian society, especially in state administration, the process of integration is seen as an end in itself. Albania's efforts for economic and democratic development should not be seen merely as tools for integration into the EU, but as the positive processes of each country in transition. So integration should be understood as a path toward democratization and welfare.

Another result that shows a clear misunderstanding of the integration process is the fact that most respondents considered as the main benefit from this process the freedom of **movement**. A very interesting result is that even State Administration, Media and NGOs praise much more the free movement than economic development and strengthening the rule of law and democratization. Here we have a double misunderstanding.

*The first* is, free movement - as a phenomenon; which is simply understood by the respondents as an opportunity for individuals to travel abroad without visas, and not as a free movement of capital and business.

*Secondly*, most respondents did not understand the fact that free movement would be only a secondary consequence of EU membership and not very valuable unless there is economic development and democratization. Instead, the attention of these groups to be focused on achieving these goals, it resulted the contrary: most people seem willing to leave Albania and see integration as a way to achieve this goal, which is very disturbing, especially the State Administration.

The survey recommended that the campaign to focus on the following:

- Should clarify the benefits and costs, which will be from Albania's EU integration process.

- It is necessary to undertake accurate quantitative analysis on the real cost of integration and especially on the positive but also negative effects that will have the Stabilization and Association Agreement on the Albanian economy. The results of this analysis should be made public.

Based on these recommendations it is born the idea for a study which made a qualitative assessment of the effects of integration, and in a second step to be

evaluated through scientific methods of quantitative effects positive / negative of the integration process in the Albanian economy.

### **Types of effects of integration in the European Union**

All the effects of EU integration can be divided into direct effects and indirect effects of integration. Direct effects can be evaluated, and they have a more precise quantitative definition. Indirect effects, first, related to sectoral effects, the effects of resource allocation and the effects of redistribution of income and wealth. These kinds of effects are more difficult to be estimated by quantitative methods.

#### ***Main direct effects of integration***

1. *The effect of diversity in trade (Trade diversion effect)* (Strapec 1999) (change of direction of foreign trade from one partner to another, due to price' changes in the countries where the goods are traded. When you are net importers- a price drop in imports results in profit, while when you are a net exporter- a price drop in exports is a cost).

2. *Effect of balance of payments* (which means: influence on the balance of payments due to the two previous effects).

3. *Government revenues* (which means: changes in budget revenues as a result of the gradual elimination of tariffs, which leads to lower income from unit import price, resulting in a short term negative effect on governmental income, but in the long run it turns out at a high level of total income (based on trade theory) that derives from increased volume of trade as a result of lowering the price per unit.)

4. *The effect of consumer welfare* (based on consumer welfare effects as a result of the deployment of lower imports' prices).

#### ***Main indirect effects of integration:***

1. *Sectoral effects* (influence on production, employment and trade sector).

2. *Effects on allocation of resources and redistribution of income*

3. *Effects on trade relations* (which means that terms of trade change due to changes in export-import balance).

4. *Effects in improving the international competitive position of a country integrated into the EU* (due to cheaper imports' factors and lower costs which are the result of gradual elimination of tariffs).

Other authors (Baldwin, François & Porters, 1997) cite the following effects:

#### ***Effects of trade:***

1. *The effect of trade liberalization and expansion; effect of trade diversity; effect of pure profit* (as far as the sectors where the domestic price is higher than the average cost of production is concerning, an increase of production increases welfare (benefit) until the marginal value of extra output (price) exceeds the extra cost. A drop in production leads to the opposite result (cost)).

2. *Accumulation Effects* (these effects are determined by the channels through which trade agreements can vary the level of national resources, particularly capital stock. This is completely different from the effect of allocation; which means the

removal of some resources from one activity and placing them in another one, but without changing the total level. Referring to their typical nature, the effects of accumulation have greater impact on GDP (Gross Domestic Product) than the effects of allocation);

3. *Reduction of trade costs* (this effect is due to the reduction of costs because of tariffs' elimination quantitative restrictions, the elimination of various barriers and facilitating procedures for clearing of goods).

***The effect of "extra" risk:*** the positive effects of increasing gross domestic product (GDP) and foreign direct investments (FDI) due to reduction of political risk which positively affect the new private investment. This effect is very important for Albania, as this country is so much threaded by this type of risk, due to political developments during these years.

***Costs and Benefits of the budget in the two cases above.***

The classification of effects which is recommended for Albanian integration in EU is done under four main categories:

***Budget-transfer effects:*** where all the countries of Central and Southern Europe (CEEC) including Albania are classified in net user grants (PHARE, CARDS, SAPARD, ISPA, IPA, TEMPUS, and the funds allocated by the EU during the first EU-Accession), These transfers affect the growth of investment, public expenditure, income of farmers and ultimately the growth of GDP for countries to integrate into the EU.

***Indirect economic effects-the benefits:***

1. *Allocation effects* (these effects are significant for countries that become full member of EU, in terms of *full competition*. They also present even for the countries as Albania, which are in early stages of European integration, in terms *incomplete competition*. This effect is related to consumer welfare, which means reducing the monopoly price, increased production limits, positive effects as a result of the diminishing of monopolistic price and market segmentation).

2. *Effects on foreign trade.*

3. *Price effects of trade* (which is based on the difference between higher local prices and lower imports' prices).

***Integration costs for joining the EU family:***

1. *Negative effect on production*, (which means declining production and rising domestic unemployment due to exposure to foreign competition

2. *The state budget is aggravated* due to the costs that have social programs that affect employees who lose their jobs

3. *Institutional restructuring costs* in line with EU requirements

4. *Costs of implementing the rules arising from the *acquis Communautaire** (Community Acquisition) (the most important are those in the field of environmental protection in the field of agriculture, food and consumer protection in the field of transport, energy and legislation).

**Indirect political benefits:**

1. Growth of national and international security
2. Using the geo-strategic advantages as the result of EU integration
3. Favor (support) for the establishment of stability, implementing democracy and rule of law.
4. Increase of FDI's, due to political risk reduction

Judging on their generality, costs and benefits of EU integration can be divided into:

**Macroeconomic effects:** effects on the state budget and the balance of payments, the effects on macroeconomic indicators such as the effect on GDP, the overall level of prices, the FDI-in, employment, consumption and investment.

**Microeconomic effects:** the effects of consumers and producers, effects arising from price changes, the allocation of resources, the redistribution of income, etc..

As far as the timeframe is concerning; effects of integration can be analyzed in terms of *short, medium* or *long term*

Main sources of costs and benefits derive by: implementing regulations, use of different institutional commitments, various forms of integration-which are subject of a detailed survey of all sectors for integrated countries. Examples of this can be:

1. Support of EU financial (*benefit*), through its instruments during the period of integration for aspiring countries: programs like PHARE , CARDS, SAPARD, ISPA.
2. EU funds (*profit*), used by less developed countries (structural funds, cohesion funds and the CAP (common agricultural policy)).
3. Competition (*profit or loss*) resulting from the creation of free trade zones, the customs union, common market of the European Monetary Union in Europe (BME), etc
4. Costs and benefits of implementing the *Acquis Communitarie (Community acquisition)*.
5. The effects (*positive or negative*) resulting from the free movement of labor, capital, goods and services.

To conclude this part of the analysis, it must be said that: specific effects of integration (mainly direct effects) can be assessed by quantitative (and even exactly) and some other (mainly indirect effects) not (for ex: political effects).

It is imperative that countries, which are integrated, have a suitable model of macroeconomic and statistical data sufficient, in order to apply appropriate technology Econometric Mathematics; for achieving a successful quantitative assessment of these effects.

### **Qualitative Assessment of costs and benefits of Integration in EU for Albanian Economy**

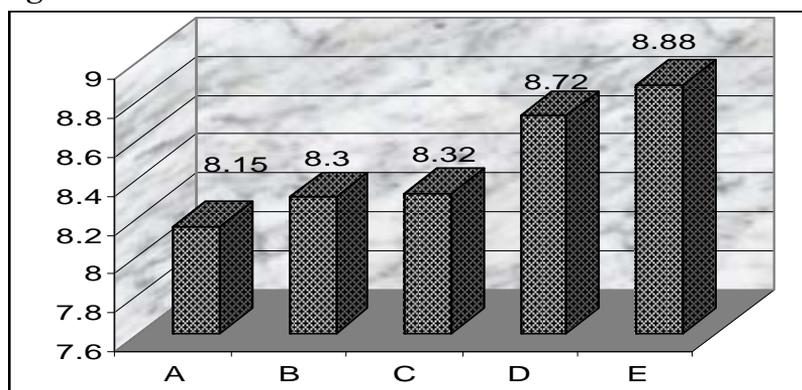
Very often, Local businesses are facing dilemma: Is it in their interest the Albanian Membership in EU or not?

As previously told, referring to the gathered data on the survey undertaken, it is calculated that:

**Question:** *People have different opinions on the benefits it would bring EU membership for Albania. In your opinion, how will Albania benefit from this membership in the following areas? Please evaluate on a scale of 1 to 10, given how much larger the number, the more you think that Albania will benefit in that direction. (Results Figure 1)*

**A.** Welfare **B.** Consolidation of Democracy **C.** Strengthening the Rule of Law  
**D.** Economic Development **E.** Free Movement in EU countries.

**Figure 1**



Of the four groups, it is calculated that businesses had lower scores. So if we refer to table below (Table 1) and collect averages for each group, business notes 39.46, 43.4 Public Administration, Local NGOs and Media respectively 44.31 43.19.

The group "business" is pessimistic regarding the expected benefits from integration in the EU and more optimistic about this phenomenon are presented representatives of NGOs. It should also be noted that, while the main benefit business group was supposed to be Economic Development, the three other groups are for free movement in European countries. Also, the standard deviation was higher in the "business" group, which means that this group is more heterogenic referring to more variable responses.

**Table 1 : Survey results**

<i>Group</i>	<i>Business</i>		<i>Local NGOs</i>		<i>Public Administration</i>		<i>Media</i>	
	<i>Mean</i>	<i>St.Dev</i>	<i>Mean</i>	<i>St.Dev</i>	<i>Mean</i>	<i>St.Dev</i>	<i>Mean</i>	<i>St.Dev</i>
<i>Welfare</i>	7:33	2:37	8.88	1:30	8.78	1:50	8:23	1.92
<i>Consolidation of Democracy</i>	8:51	1.96	8.9	1:32	8.78	1:46	8.80	1:44

<b>Strengthening the rule of law</b>	7:94	2:34	8:43	1:50	8:19	1.74	8:23	1:46
<b>Economic Development</b>	7:26	2.60	8.95	1:40	8.60	1.64	8.91	1:59
<b>Free Movement in EU Countries</b>	8:42	2:31	9:15	1:39	9:05	1.65	9:02	1:58

Source: Author's calculations

Advantages associated with the EU integration include a better chance of presence of Albanian products in EU market. An important benefit is that the country is obliged to adopt an economic strategy that promotes competition, and thus a more efficient allocation of resources. EU integration will have long term effects for the Albanian economy, including being part of a large market, which brings several benefits associated with economies of scale and a favorable environment for FDI-in. Moreover, Albania has to enhance standards and legislation in line with those of Western countries, which will be accompanied with positive impact, even in the environmental field. Albania is going to attract more FDI due to a more harmonized legislation, a free movement of goods and services and economic and political stability.

The cons arguments on the Albanian integration are linked with the removal of import controls, which leads to loss of output and employment in firms which are favored due to protectionism. It is also thought that Albania would lose from the EU integration, while it must adopt a whole legislative system of western countries. Another concern is referred to the possibility of losing "sovereignty" (emphasizing that it would limit freedom of taking decisions by the Albanians as the decisions will be taken by the EU and Albania as a small country will not have much strength in European decision-making).

The table below (Table 2) presents detailed cost and major benefit of integration of Albania into the EU.

**Table 2: Costs and Benefits of Albania's EU integration**

<b>Changes related to integration</b>	<b>The main benefits of integration = costs of non integration</b>	<b>The main cost benefits of integration = benefits of non integration</b>
<i>Free trade (freedom of movement of goods and services)</i>	Reducing the price of imports, production more efficient and better acceptability of Albanian products in the EU, the comprehensive effects on domestic production.	Albanian manufacturers' inability to cooperate with modern international competition, which leads to loss of jobs and income.

<i>Internal competition</i>	The elimination of monopolistic and oligopolistic structures, leading to lower prices and higher quality products to customers. Encouraging free trade.	Loss of profits that come from the removal of exclusive practices (monopoly). Since the Albanian firms are unable to cooperate in the elimination of monopoly and oligopoly structures they will suffer the reduction of profits as a result: the lowest price in the market (high competition) and the demand for higher quality for their products.
<i>Agri-culture and agro-industry</i>	Local agricultural sector will become more competitive and Albanian farmers will be able to benefit from the CAP (EU funds, under the agricultural sector).	Agriculture and Agro-Industry of Albania will have difficulty to survive the competition. Products and main meals will be imported more cheaply because of lower prices and higher quality in comparison with domestic ones.
<i>Inflation</i>	The harmonization of fiscal policies with monetary policy, fiscal consolidation will aim to lower rates and controlled inflation in the country.	Strict fiscal and monetary policies aimed at keeping inflation in the limit set cannot have more positive effects versus economic growth, thereby reducing the options for policy-makers.
<i>Public Procurement</i>	Intensification of competition should lead to reducing the cost of public procurement, targeting the best of the best	The opening of public procurement for non-Albanian bidders would not serve the interests of local businesses, while Albanian contractors will not be able to compete with contractors on foreign firm.
<i>Freedom in capital movement and financial services</i>	Such freedom would result in the reduction of commissions from financial institutions and greater availability of credit. The removal of monetary	Liberalization process in financial and monetary sector will be associated with the removal of restrictions on mobility of direct investment

	exchange controls will lead to more efficient use of funds.	flows within and abroad, accompanied with the possibility of property speculation by non-Albanian citizens. In this way, foreigners can buy some real estate in Albania (taking advantage of lower prices in the country and the high level of income that they have) giving them the opportunity to speculate in this regard.
<i>Business behavior</i>	<p>Business will become more oriented towards efficiency and initiative, becoming less dependent on phenomenon of protectionism.</p> <p>There will be a tendency towards consolidation of business activities.</p>	<p>Given that the domestic business will face a higher level of competition (lower prices and higher quality products), some small businesses, being unable to compete may be closed, leading to reduction in the level of their income and increasing unemployment. This cost can be reduced by policies encouraging the development of local small business undertaken by the Albanian government.</p>
<i>Structural and Cohesion Funds</i>	<p>Albania will be legitimate for structural and cohesion funds from the EU, this will help improve the infrastructure, environment, providing among other things, more training opportunities and assistance in these sensitive areas.</p>	<p>The integration process will create the opportunity for Albania to be the beneficiary of grants and loans from the EU, several times more than currently. This will make foreign countries being more present in the country, affecting not always positively to the development of initiative (initiative) Albanians private.</p>
<i>Job Market</i>	<p>Work will become more mobile (mobile), and will improve the welfare of</p>	<p>Given that many foreign firms will have activity in our country, it will employ many</p>

	employees through health and safety measures through the establishment of maximum limits on working hours, etc..	Albanians. Based on the competition in the field of employment, the Albanian business will impose additional costs to pay for improving the welfare of workers. Moreover there is the possibility of "leakage" of the brain (brain drain phenomenon) (skilled workers tend to be hired abroad in the EU, which also paid more)
<i>Foreign Direct Investment (FDI)</i>	Economic stability, law and harmonized standards in the U.S. will attract FDI from the EU and other non-EU.	Given that Albania has very cheap labor force, many foreign businesses will operate in our country in this way: They import raw materials and industrial equipment with zero tariff on final products which are re-exported. Upon integration into the EU, Albania needs to adopt a common tariff system for imported products from outside Europe. So the removal of zero tariffs on raw materials imported from non-EU countries will cost more to foreign businesses, and this can affect in discouraging FDI in Albania.
<i>Building standards</i>	This will result in better quality and safer product, which will create better conditions for acceptance of Albanian products in European markets.	Albanians should afford firms an additional cost for setting standards; otherwise they will be unable to operate in conditions of full competition arising from integration.

### Quantitative methodology for assessment of effects for EU integration.

Considering the aforementioned factors; and considering a very long literature review; I found that the models/ techniques mostly used by researchers for quantitative evaluation of costs - benefits of EU integration for the countries of Central and Eastern Europe are:

1. *CGE model* (Computable General Equilibrium, General Equilibrium value) one of his alternative may be the partial equilibrium framework.
2. *Macro Model* - mostly static analysis based on previous experiences
3. *Sector Assessment* - (mostly static)
4. *Gravity model* - ( focused on the effect of trade)
5. *OCA model* (Optimum Currency Area-optimal currency area, in the case of European Monetary Union, the Euro zone is OCA)

Features are presented briefly below CGE model, the gravity model and the model OCA:

#### a) *CGE Model*

This type of model can be considered as a model of sectoral assessment. Moreover, CGE models are frequented by researchers of the countries of Eastern Europe. History of CGE modeling starts from 1960 when the first model was built for multisectoral development from Norway L. Johansen (Johansen 1960). Many other models were built further from the pioneer of modeling. Modelers in the context of other World Bank projects have contributed to the standardization of CGE assessment, using the database as a SAM (Social Accounting Matrix, SAM) and software packages such as Gams or GEMPACK.

One of the main *advantages* of this technique is that it offers the opportunity to design a direct or indirect links between sectors. Original model, using factors of production (labor and capital) are combined by ex post (CES- constant elasticity constant elasticity of Scale). As a *disadvantage* of the model, I can mention the fact that the work pattern is assumed to be constant, accepting as true, the fact that the economy is at full employment conditions (which really does not happen, therefore this phenomenon is considered as a disadvantage).

Another *disadvantage* of this approach is that, most models rely on an old data base, which refers to a base year. Referring to cases where CGE model is applied to several countries simultaneously, no CGE model is able to assess or predict how the total benefits from EU integration is distributed among new EU members,

Another negative aspect of a CGE model is its static nature of the simulation. However, this can be overridden by dynamic modeling of general equilibrium by Keuschnigg and Kohler (1998).

It is to be stressed the fact that CGE models are based on the concept of static equilibrium and thus use the method of comparative studies, or in other words *the sensitivity analysis*. Numerical values that wear the model parameters, which results from actual or projected values of economic variables. The model itself is calibrated so that the initial values of endogenous variables (*or scenario-based solution*) to satisfy

equations of the model (assumed requirement equilibrium).

Below in the form of a table it is presented advantages and disadvantages of the CGE model:

**Table 3: CGE Model**

<i>Advantages</i>	<i>Disadvantage</i>
<ul style="list-style-type: none"> <li>Models allow assessment of:</li> <li>monopoly competition,</li> <li>economy of scale,</li> <li>capital accumulation</li> </ul>	<ul style="list-style-type: none"> <li>SAM-input for the model - generally database updated periodically in long periods and thus invalidated the results appeared at the end of the respective periods.</li> </ul>
<ul style="list-style-type: none"> <li>Sectoral interaction among a country's economy.</li> </ul>	<ul style="list-style-type: none"> <li>There are not realistic assumptions about full employment and perfect movement of production factors (transition, integration and acceptance into the EU then increase the probability of a higher unemployment)</li> </ul>
<ul style="list-style-type: none"> <li>The effect can be simulated using dynamic data of a stable situation through the model (it is meant the assumption of a perfect prediction).</li> </ul>	<ul style="list-style-type: none"> <li>Weak-specification dynamic "time frame" is the inevitable part of the model (It might be investigated only a limited time horizon, for example. The final state of economic equilibrium)</li> </ul>
<ul style="list-style-type: none"> <li>The possibility of simulation of structural or sectoral effects, and global macroeconomic effects.</li> </ul>	<ul style="list-style-type: none"> <li>The model is based on economic structure, but relatively constant in the transition period (period of major structural changes); this feature is a disadvantage; input-output data bases should be updated as often as possible.</li> </ul>
<ul style="list-style-type: none"> <li>CGE accompany microeconomic mechanisms and institutional features within a stable macroeconomic framework (allows analysis of structural changes under different assumptions)</li> </ul>	<ul style="list-style-type: none"> <li>Economic restructuring process makes the system unstable and consequently it results less reliable.</li> </ul>

*b) Gravity Model*

Gravity model is focused on explaining the bilateral trade relations based on ration of per capita GDP to total GDP and geographical distance between trading partners. This "greedy" framework, despite its simplicity, explains the importance of significant trade effects in the process of integration.

Theoretical explanation in the form of the equation is as follows:

$$X_{xi} = \beta_0 + \beta_1 \left( \frac{GDP_i}{POP_i} \right) + \beta_2 GDP_i + \beta_3 \left( \frac{GDP_x}{POP_x} \right) + \beta_4 GDP_x + \beta_5 Dist_{xi} + Dummy$$

Variable +  $\epsilon_{xi}$

All variables used in the equation are in logarithm.  $X_{xi}$  represents exports from the exporter (country x) to the importer (country i). GDP, POP, and Dist, respectively represent the total GDP, population and distance between the two countries, the respective ( $\epsilon_{xi}$  is the error of duality, which is not explained by the model itself). The parameters are as follows:

- $b_1$ ... elasticity of demand for income importers,
- $b_2$ ... reflects the size of the effect on the country which imports,
- $b_3$ ... indirect measures of the capital labor of the country which exports
- $b_4$ ... "how big should be the level of differentiated product which should be offered by a country)"

In general, gravity models refer to the flow of trade between two countries on the request of importers, exporters and bid the cost of trade. Requirements of importers and exporters offers are replaced by the GDP of countries with GDP per capita. It is used as a measure of the cost of trading one form of geographical distance (chosen by the researcher).

Below in the form of a table there are presented advantages and disadvantages of the gravity model:

**Table 4: Gravity Model**

<i>Advantages</i>	<i>Disadvantage</i>
<ul style="list-style-type: none"> <li>• Simple and easy "s' appearing."</li> </ul>	<ul style="list-style-type: none"> <li>• Focuses only on trade.</li> </ul>
<ul style="list-style-type: none"> <li>• Despite the limited context of its simplicity, the model explains quite well the behavior of the trade.</li> </ul>	<ul style="list-style-type: none"> <li>• The model is based on no empirical/intuitive evidence – but there is a strong experience on the theoretical support.</li> </ul>
	<ul style="list-style-type: none"> <li>• It is much more a study on the "Potential" trade effect than predicting the real value of this effect based on empirical evidence or dynamic forecasts.</li> </ul>
	<ul style="list-style-type: none"> <li>• Static nature of the sample, which means for example: Inability to take into account unforeseen changes in political regime.</li> </ul>

The gravity model appears to be almost perfect in particularly assessing the possible trade between the two neighboring countries or groups of countries. However, only a fraction of the possible effects (especially the effects of creation and trade diversion) can be determined by the model. Therefore gravity model is applicable, as in the case of sector models as a pre-analysis for more complex simulations. Results of gravity models seem to have great impact on contribution for determining the proper variables / inputs / instruments rigorous (to create such appropriate base scenarios) for further dynamic modeling.

*c) OCA model*

Theory of Optimum Currency Area (OCA) (Euro zone), is based on analysis of conditions that countries must satisfy in order to have positive effects, in case joining the monetary union. As a result, these countries may face "asymmetric shocks due to different structure they have. (Baldwin 1997). Being in lack of instruments -, such as "exchange rate" - they will require more flexibility in their labor markets to counter asymmetric shocks.

The theory confirms the reduction of cost for eliminating exchange rate instrument due to the existence of an open market economy.

In general, monetary union seems not very attractive for CEEC countries. These countries have fragile economies, and pretty soon they fall in asymmetric shocks situation (example: high inflation in a country, and unemployment in another). One of the main problems when using modeling OCA is an unknown relationship between economic integration and the existence of asymmetric shocks.

From the methodological point of view, OCA has identified three groups of factors, which are important in determining the benefit from monetary union:

- The level of trade integration in the EU and CEEC countries development) (Mc Kennan, 1963)
- Size and frequency of asymmetric shocks (for a specific country) their (Mundell, R. 1961, Bofinger P, 1994)
- The degree of labor market flexibility. (Frankel and Rose 1996)

Generally speaking, the dynamics of monetary integration are described while using a graph, in which the degree of the economic and employment divergence (between a particular country CEEC and the EU) are set on the vertical axis, and measures the degree of integration trade between them are located in the horizontal axis. The so-called "OCA line" connects all the points of divergence and the combination of integration, indicating zero net benefit line with the monetary union. While the economic divergence between agents taken into account is positively growing; integration of trade should be increased to eliminate a negative effect on divergence. So OCA line has positive slope. Authors generally choose CEEC countries to the left of the line due to the assumption of high economic divergence and low trade integration comparing with other members of European Monetary Union.

Below in the form of a table there are presented advantages and disadvantages of the OCA model:

**Table 5: OCA model**

<i>Advantages</i>	<i>Disadvantage</i>
<ul style="list-style-type: none"> <li>• The model can be presented graphically, so it is easy to be described and understood</li> </ul>	<ul style="list-style-type: none"> <li>• It is not possible sensitivity analysis or quantitative analysis; other measurements must be carried out on a more empirical analysis.</li> </ul>

• Another alternative view on the effects of European Monetary Union.	• The model is specifically focused on trade and the divergence / flexibility.
• The model uses panel data, so the effect is considered dynamic.	• The model is based more on empirical evidence rather than theoretical framework.

The same as gravity model, the methodology OCA studies the effect of only one type of integration (integration effects of the European Monetary Union). Furthermore, the theory is based on empirical evidence and is much more focused more on evaluating the effects of monetary union in associated countries.

## Conclusions

Each of us is aware of the special and vital importance of the process of integration of Albania into the European Union. This integration is the objective of each structural state, and individual in our country. Besides the fact that integration is an enviable process for all; it is imperative that everyone be aware that before the integration brings benefits, some cost has to be “paid”.

Therefore it is necessary to undertake scientific studies to assess the effects of integration. Based on the experience of current candidate countries for accession to the EU, It is a must for Albanian economy to build a suitable model for assessment of the quantitative effects of integration.

Empirical results should be known to the public and should be taken into account by political decision-making bodies

The main benefits consists in new opportunities arising from the integration of exports in foreign markets; increase of competition and improvement of efficient structures, which in the long run will strengthen the Albanian economy to face international competition. The integration of countries into the EU has already shown that a more liberalized environment will help the country to benefit more. Costs occur mainly by changing the position of the economy: from a protected economy to an open one, competitiveness on its own leads to loss of income and employment. It should be kept in mind that a very small proportion of Albanian firms are used to face the terms of exposure in a competitive international environment.

In terms of Albania, given the poor level of diversity and reliability of historical data in country, you can apply the above models based on several assumptions and limitations that will become available in the future empirical study of the author. This study will serve the central institutions, academic ones and businesses; in order to help them to better understand the effects of Albania's EU integration, the importance and direction of these effects.

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**FINANCIAL-ACCOUNTING ASPECTS REGARDING FAMILY ALLOWANCES***Iuliana Cenar\****Abstract**

*The importance of family and ensuring its social protection are indisputable in any society. It is the reason why in this paper we plan to create an overall picture of how social protection is achieved through family allowances and other social benefits, as well as the role of accounting in this process.*

*Thus, we considered appropriate to present the institutional and legal frameworks for the social protection of the family thorough family allowances and additional social benefits related to them, the dynamic of the dimensions regarding quantity and value and the bookkeeping of the social benefits for families by the public institutions involved in managing the financial resources allotted by the government for this purpose.*

**Keywords:** family allowances, accounting, social protection, public institutions, financial support

**JEL Classification:** M41, A14, K36

**Introduction**

The family is the fundamental institution in all societies, the basic social form established through marriage, consisting of a husband, a wife and their descendants [DEX, (1998)]. From a sociological perspective, the family is “a group of people joint through marriage, blood or adoption”, “the oldest and most important of all social institutions, ..., the heart of political, economic and educational activities that take place up until their socialization”. [Agabrian, (2003)].

As a reference point of stability, the family ensured the survival of the individual and the reproduction of society, the preservation of traditions and national values. The multiple changes in contemporary society have also left their mark on family, causing important transformations. However, the social protection that was achieved through various social services remained a necessity.

Social services are a set of complex measures and actions designed to meet the social needs of individuals, families or groups in order to prevent and overcome situations of difficulty, vulnerability and dependency. Family allowances are included within the measures to promote social inclusion and to improve quality of life.

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The issue of family allowances is approached in detail by legal regulations and by the literature of social insurances and protection, but, perhaps paradoxically, it was less approached in terms of accounting. We believe that this perspective is able to strengthen the segment of social accounting, which has the human resource at its core. The family is the human resource on which we will focus our attention (not the employee, unemployed, beneficiary of scholarship, retiree, etc.).

Accounting is intended to illustrate the life of entities, being, as professor Bernard Colasse said, “a social product of information, strengthened through practice over a history of five centuries...”. Therefore, in our approach to investigate the financial accounting information regarding family allowances we will relate to the entities of the public administrations that carry the responsibility of their management, namely municipalities and regional labour and social protection directions.

As public institutions, the role of municipalities is to manage and resolve the public affairs of the towns and cities where they operate, a role given due to the reasoning that they are the closest to the citizens. The labour and social protection directions are decentralized public services of the Ministry of Labour, Family and Social Protection, which, among others, is responsible of managing and administering social benefits and of running activities in the field of women’s rights and family policies.

Social life takes place within territorial human communities. These are perceived as [Pascaru, (2003)] groups of people who live within a certain social division of labour, in a certain geographical area, having a common culture and a social system of organizing activities.

We propose a pragmatic approach of the financial accounting aspects regarding family allowances, noting, however, that by using conceptualization we can’t issue infallible verdicts regarding their status within social protection. Why? Because social insurances and social assistance are two major components of social protection, but, in the first case, social benefits are given in exchange for contributions paid previously, while social assistance is for people without minimum existential resources.

However, it is clear that these social benefits are a financial support given to the family, regardless of its social status, and the entities in the public sector play multiple roles in this process (managing, financing, collecting / supplying information, etc.).

### **The legal framework and the characteristics for family allowances and social benefits associated to them**

The presentation of the main normative documents that establish the legal patterns for family allowances uses as first reference the family and its forming. Therefore, by relating to family and to the granted forms of support, we can mention the following legal regulations with subsequent amendments:

- Law no. 396 of October 30, 2006 on the granting of financial support for

setting-up a family;

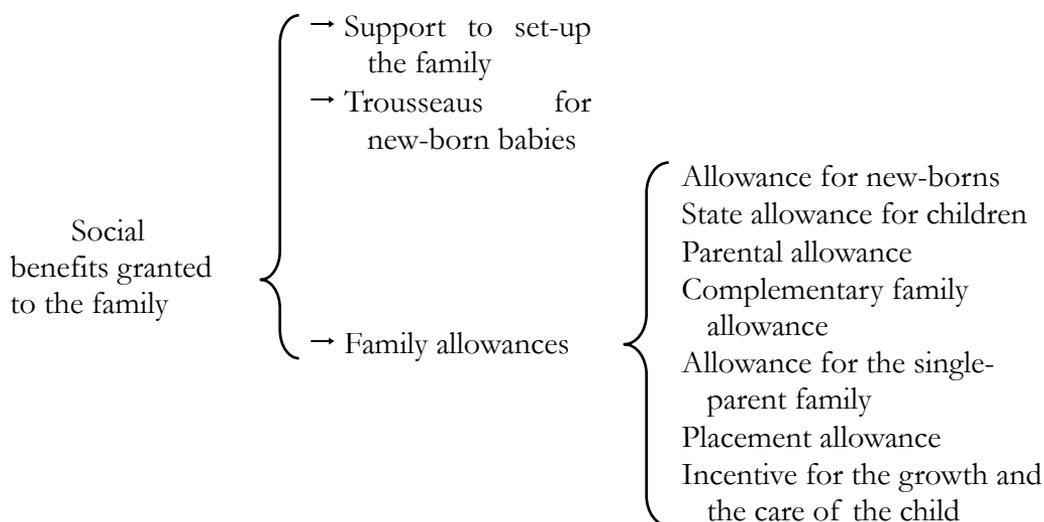
- Law no. 482 of December 19, 2006 on the granting of trousseaus to new-born babies;
- Law no. 461 of July 18, 2001 on the guaranteed minimum income (allowance for new-borns);
- Law no. 61/1993 regarding state allowance for children;
- GEO no. 105 of October 24, 2003 regarding the additional family allowance and the allowance for the support of single-parent families;
- GEO no. 148 of November 3, 2005 regarding the support of the family in raising children, etc;

The Constitution of Romania stipulates the following: “children and young people enjoy special protection and assistance in achieving their rights. The government grants state allowances for children and benefits to support children who have an illness or disability”.

Gradually, supporting children has a precedent in the support of people who want to set-up families from where these children will come, both of them being dimensions of social policies. The actual forms of support are the operational instruments of intervention of the state and of public authorities.

The schematic structure of the social benefits granted to the family is as follows:

### Scheme no. 1. Types of social benefits granted to families



Thus, setting-up a family in which both spouses are at their first marriage is supported by public authorities through a (symbolic) *financial support* of the family.

Each new-born has the right to a free *trousseau* that includes clothes, linen and care products. It is given once by the local public authorities when the child leaves

the maternity ward or when the birth certificate is issued.

The long period of time needed to go through all the steps stipulated by the legislation regarding public acquisitions in order to procure the products of the trousseau, the diversity of the products existent on the market and the volume of the acquisition, the difficulties in finding a supplier that provides all the necessary products led to the decision to give the family the equivalent money value of the trousseau starting with January 2007.

The *allowance for new-borns* is given to mothers for each of the first 4 children born alive, obviously once for each child.

The *state allowance for children* is a form of monthly financial support given by the government to families with children. It represents a universal right for all children under 18 years old (including children who turned 18 and are attending high-school or a vocational school up until they graduate).

The beneficiaries of this type of financial support are: children who don't attend school, children who attend compulsory general education, children under 18 years old and young people who turned 18 but are attending school, according to the law.

The *parental allowance* is granted to one of the parents of the new-born, who, in the year previous to the child's birth has earned for 12 months professional incomes subjected to the income tax. This allowance may be granted to any of the child's parents until the child turns 2 or, in the case of a disabled child until he/she turns 3.

The *support allowance for the single-parent family*, which consists of one person and children under 18 years old, is granted in case the monthly net income per family member is below a certain threshold value.

The single person is in one of the following situations: single; divorced; widowed; the spouse is declared missing by court order; is in preventive custody for more than 30 days or is serving a jail sentence and he/she doesn't participate in the support of the child.

The condition is also available for the *complementary family allowance*.

The solution of the requests regarding the granting of the two types of allowances is conditioned by a social investigation at the home of the applicant, which verifies the information written in the documents. These allowances are paid during school holidays also.

The *placement allowance for children in foster care* is given monthly for each foster child.

The *monthly incentive for the growth and the care of the child* is given to people who have the right to receive the parental allowance but decide to go back to work before the expiration of the two years of parental leave they are entitled to.

The granting of social benefits is conditioned by the compiling of an application by the applicant / recipient addressed in most cases to the town hall, but also to school units (for the state allowance for children who attend compulsory general education) or to the General Directorate of Social Assistance and Child Protection (when the applicant requests the state allowance for a disabled child).

The application must be accompanied by different documents, depending on the nature of the benefit (for example, a copy of the birth certificate, statutory declarations, documents showing the members of the family and its incomes in case the allowance is conditioned by the size of the incomes).

Municipalities are obligated to periodically communicate to the regional labour and social protection directions various information, depending on the nature of the allowance. The information may regard:

- The number of families that received financial support, the age and citizenship of the spouses and the paid amounts;
- Summary statements regarding the mandates of the mayor and the beneficiaries of the trousseau for new-borns;
- The mandate to establish the rights to the complementary family allowance or the support allowance, together with the request of the applicant approved by the mayor;
- The registered applications for the state allowance for children (for children who don't attend school) and the situation of children who died.

It may be concluded that the information circuit follows the trajectory: applicant/ beneficiary - Town hall - the Regional Labour and Social Protection Direction - the Ministry of Labour, Family and Social Protection

Public institutions are crystallizations of social relationships, therefore, it is estimated that it is ideal for public institutions and structures to be the ones reflecting the aspirations and value choices of the people. Thus, like all public institutions, municipalities deal with the mediation between the expectations of the members, the targeted goal and the environment conditions associated to human action.

The financial supporter of family allowances is the state, because all of the mentioned types of allowances are financed from the state budget. The payment to beneficiaries is done by town halls or labour and social protection directions, the necessary funds being ensured through the Ministry of Labour, Family and Social Protection.

Depending on the "social status" of the child, the necessary budget appropriations for the payment of state allowances for children are managed by the Ministry of Labour, Family and Social Protection (for children that don't attend school), by the Ministry of Education, Research, Youth and Sport (for children who attend compulsory general education, namely one of the education forms organized according to the law) or by the National Authority for People with Disabilities.

### **Value and number sizes of family allowances**

For certain types of social benefits the value was kept constant. This is the case for the allowance given for setting-up a family – 200 euro, the trousseau for new-borns – 150 lei, the state allowance for children up to 2/3 years old – 200 lei, while for other allowances the value was changed annually.

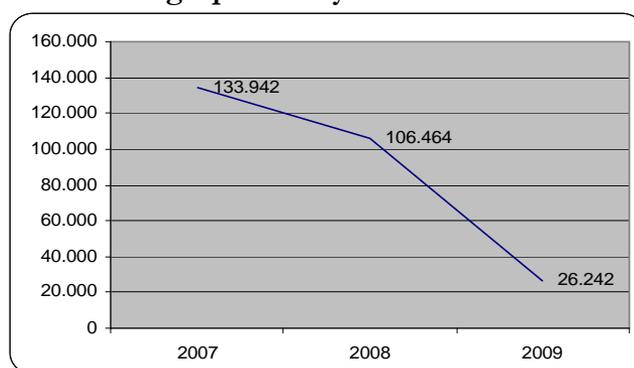
For the trousseau for new-borns the legislation stipulates the annual updating

and indexation depending of the inflation rate and based on a Government decision. However, its value wasn't changed since 2007.

In terms of the quantitative dimension, we may say the evolutions fluctuate from one year to the next.

Keeping up with the timeline, the chart below shows the numerical evolution of the beneficiaries of financial support for setting-up a family for the years 2007, 2008 and the first quarter of 2009:

**Chart no.1 The numerical evolution of the beneficiaries for financial support for setting-up a family between 2007 and 2009**

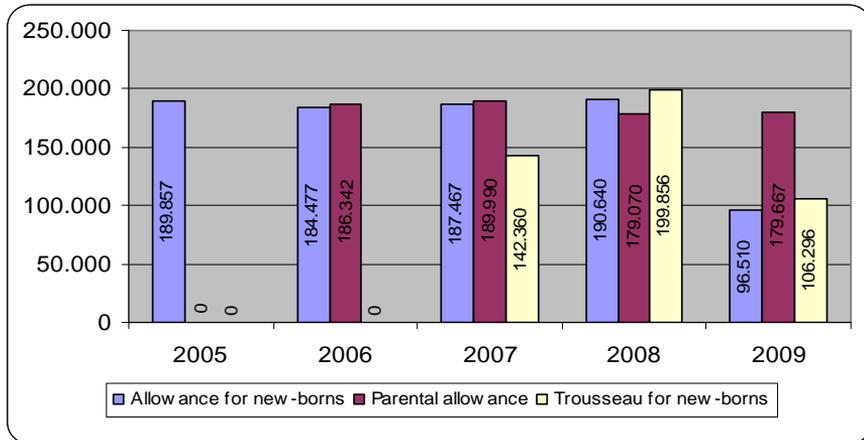


The chart's data show the descending evolution of the beneficiaries of financial support for building a family. The causes are multiple and interrelated: recent demographic evolutions, the economic context, not knowing the legislation, negligence, etc.

The trousseau for new-borns and the allowance for new-borns are intertwined since both have the same beneficiaries. They are also in a dependency relationship with the parental allowance because is granted to children aged 0 – 2/3 and the term new-born refers to a child aged up to 12 months.

The way how the numerical correlation between the mentioned categories of benefits is achieved results from the data presented in the next chart:

**Chart no. 2. The number of beneficiaries of trousseaus for new-borns, of allowances for new-borns and parental allowances between 2005 and 2009**

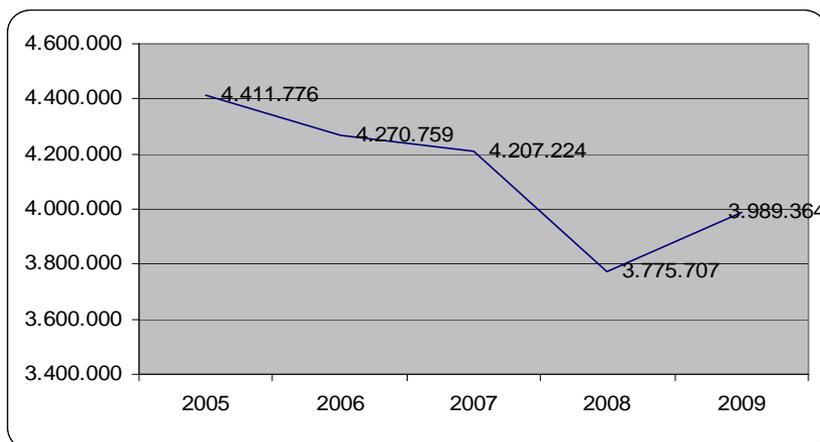


Although theoretically the number of beneficiaries of trousseau for new-borns and the allowance for new-borns should be the same, we see differences that go up to 45.107 beneficiaries in 2007. In terms of the existence of forms of social protection, we see that the allowance for new-borns prevails, being succeeded in 2006 by the parental allowance and by the trousseau for new-borns in 2007.

According to the drafts of legislation, the trousseau for new-borns and the allowance for new-borns will be substituted by a single allowance. The reasons behind this change are related to reducing bureaucracy and the administrative costs, but also to the current economic context that doesn't allow allotting additional money from the state budget.

The numerical evolution of the beneficiaries of state allowances for children between 2005 and 2009 is seen in the chart below:

**Chart no.3. The number of beneficiaries of state allowances for children between 2005 and 2009**



As can be easily seen, the number of beneficiaries of state allowances for children dropped from 4.444.776 persons in 2005 to 3.775.707 persons in 2008.

A slight increase in the number of beneficiaries was recorded in 2009 compared to the previous year, namely by 231.557. This recent evolution may be due to the fact that most employed women take into account their financial situation when deciding to have a baby and the opportunity to receive 85% of their average wages has encouraged active women to have a baby.

The evolutions of the quanta of the allowance for new-borns, the state allowance for children and the parental allowance are seen in the next table.

**Table no. 1. The evolutions of the quanta of the allowance for new-borns, the state allowance for children and the parental allowance**

Type of allowance \ Year	2005		2006	2007	2008		2009
Allowance for new-borns	186		195	204	213		230
State allowance for children aged 0 – 2 children aged 2 – 18	22,5*	23**	24	200	200		200
				25	32***	40****	42
Parental allowance	-		800	600	600		600
							85% of the average income in the last 12 months < 4.000

\* up to 1.07.2005; \*\* from 1.07.2005; \*\*\* up to 1.03.2008; \*\*\*\* from 1.03.2008

The data in the table highlight multiple aspects, such as: the ascending trend of the allowance for new-borns, as well as the state allowance for children, the descending trend (at least until 2009) of the parental allowance and its limiting to 4.000 lei; the splitting of the children allowance in two starting with 2007, the significant increase of the state allowance for children aged 0 to 2, etc.

According to Law no. 257 of October 31, 2008, starting with January 1<sup>st</sup> 2009, the person who in the year previous to the child's birth has earned for 12 months professional incomes subjected to the income tax will benefit of a monthly allowance of 600 lei or an allowance representing 85% of the average income in the last 12 months, without exceeding 4.000 lei.

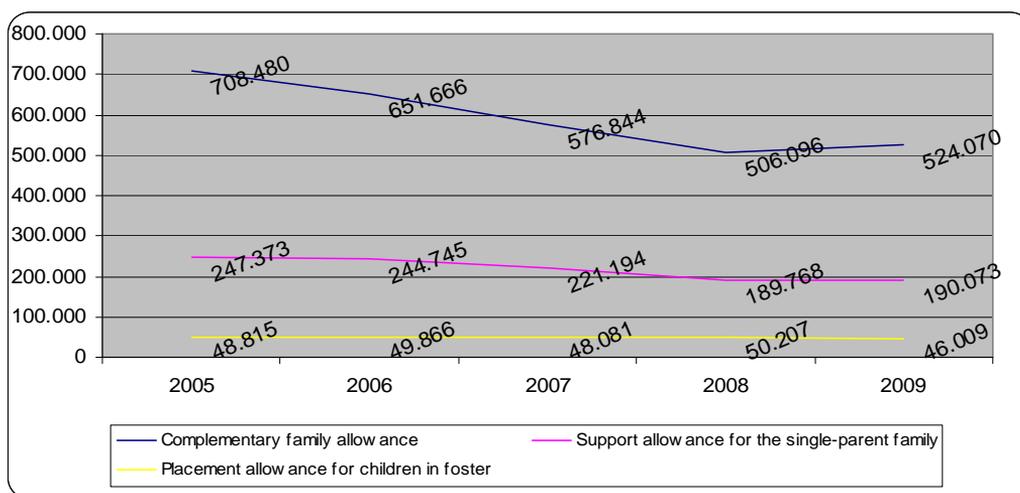
It should be mentioned that the replacement of the trousseau for new-borns

and the allowance for new-borns with the sole allowance of 350 lei will reduce the benefit of the family with 30 lei compared to the value of the benefits granted in 2010.

Also, children with disabilities receive a state allowance in an amount increased by 100% until they turn 3.

The number of people who received the complementary family allowance, the support allowance for the single-parent family, as well as the placement allowance for children in foster care between 2005 and 2009 is seen in the chart below:

**Chart no. 4 The number of people who received the complementary family allowance, the support allowance for the single-parent family, as well as the placement allowance for children in foster care between 2005 and 2009**



If we refer to the extremes of the reference period we notice a drop in the number of beneficiaries for all the three categories of benefits.

Thus, for the complementary family allowance the number of beneficiaries was 708.480 persons in 2005 and in 2009 their number was reduced to 524.070 persons. The number of persons who received the support allowance for the single-parent family was 247.373 in 2005 and after 4 years it dropped to 190.073, a decrease of 57.300 persons. The placement allowance for children in foster care didn't record significant fluctuations, the biggest being of 4.198 recipients (a modification recorded in 2009 compared to the previous year).

In terms of value, between 2005 and 2009, the monthly quantum of the complementary family allowance, of the support allowance for the single-parent family and of the placement allowance for children in foster care recorded the value seen in the table below:

**Table nr. 2. The monthly quantum of the complementary family allowance, of the support allowance for the single-parent family and of the placement allowance for children in foster care between 2005 and 2009**

Year	2005	2006	2007	2008	2009
<b>Type of allowance</b>					
<b>Complementary family allowance</b>					
- family with one child	32	34	36	38	50
- family with 2 children	38	40	42	44	60
- family with 3 children	43	45	47	49	65
- family with 4 or more children	48	50	52	54	70
<b>Allowance for the single-parent family</b>					
- family with one child	48	50	52	54	70
- family with 2 children	56	59	62	65	80
- family with 3 children	64	67	70	73	85
- family with 4 or more children	72	76	79	83	90
<b>Placement allowance</b>					
- for each child who was placed in foster care	78	82	86	90	97

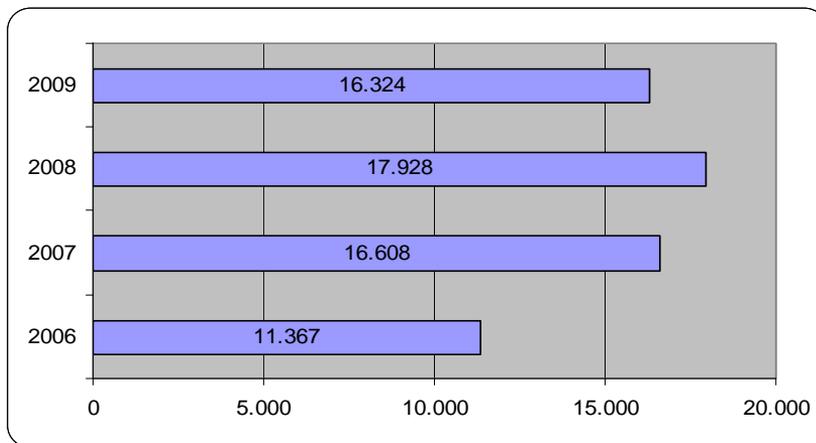
The difference between the quantum of the complementary allowance and the quantum of the support allowance depends on the number of children in the family. Therefore, in 2009, for the family with one child, the complementary allowance was 50 lei and for the family with 4 children it was 70 lei. It's obvious that although it's gradual, the variation between the levels of the allowance is extremely low, 5 to 10 lei. Thus, we could rhetorically ask ourselves if a low income on each family member and the expenses for raising a child may be compensated with 5 or 10 lei?

Another criterion of differentiation is the time factor. In this regard, we are able to see the ascending evolution of the value size for the three categories of allowances presented in the table for the entire analyzed period. Thus, the complementary allowance increased in 2009 with 18 lei compared to 2005 for the families with one child, and with 32 lei for the families with 4 children. A similar evolution is noticed for the placement allowance for which the most significant increase was 24 lei for the families with 2 children.

The maximum income limit per each family member, which conditions the granting of the complementary family allowance and the support allowance for the single-parent family, has the following evolution: 160 lei in 2005, 168 lei in 2006, 176 lei in 2007, 184 lei in 2008. Starting with 2009, the provision according to which the monthly income per family member has to be below the minimum net wage (423 lei in 2009) has entered into force.

The next chart shows the evolution of the perception regarding going back to work during the period when both the state allowance for children and the parental allowance are granted.

**Chart no. 5. The evolution of the number of beneficiaries of the parental incentive between 2006 and 2009**



We are able to see the sinuous evolution of the number of beneficiaries of the parental incentive. The maximum point was reached in 2008 when 17.928 people who were entitled to the parental allowance returned to work.

The parental incentive is cumulated with the state allowance for children. In case of returning to work, the beneficiary will receive the following: a salary from the employer; a monthly incentive from the government until the child turns 2 or 3 years old – the state allowance for children.

The quantum of the parental allowance was 300 lei in 2006, and since 2007 its value has been kept constant to 100 lei.

“Returning to work” before the parental leave expires shouldn’t be seen only for its pecuniary side. The current economic context raises growing concerns about keeping a job. Relevant conclusions could be drawn only by knowing the proportion of people returning to work who receive the amount of 600 lei and of those who benefit of incomes higher by 15%, to which the parental incentive is added.

### **Technical aspects of the family allowance accounting**

The current accounting places family allowances at the level of two categories of public entities: municipalities and territorial labour and social protection directions.

Without ignoring the accounting principle of the economic entity assumption, we thought it was necessary to present how family allowances are transposed in the accounting of both public institutions. This way, we will obtain an overall picture of the accounting technique regarding family allowances, the side of social accounting.

Although the municipalities manage a variety of supporting documents for the granting of social benefits for the family (which compose the file of the applicant, as

well as documents that are sent to the labour and social protection directions), only the following are reflected into their accounting: the financial support granted for setting-up a family, the trousseau for new-borns and the allowance for new-borns.

Next, we'll present the accounting dimension of the family allowances and of their associated social benefits (namely the three categories of benefits mentioned as belonging to the municipalities' accounting):

### The accounting of the municipality

→ showing the payment obligation of welfare:

<b>677.57.02.01</b>	=	<b>438analytic</b>	8.890
Welfare		Other social debts and claims"	

57.02.01 – the budget classification code for „Welfare in cash”

→ the payment of welfare, based on a financing account and in cash:

<b>581</b>	=	<b>7702.57.02.01</b>	8.890
Internal transfers		Financing from the local budget	

<b>5311</b>	=	<b>581</b>	8.890
Petty cash		Internal transfers	

<b>438analytic</b>	=	<b>5311</b>	8.890
Other social debts and claims		Petty cash	

### The accounting of labour and social protection directions

→ showing the payment obligation of welfare:

<b>677.57.02.01</b>	=	<b>438analytic</b>	523.680
Welfare		Other social debts and claims	

→ showing the financing that will be used to pay family allowances:

<b>4611</b>	=	<b>7701.57.5.1</b>	523.680
Various debtors		Financing from the state budget	

→ the settlement of family allowances is recorded the following month as follows:

<b>438 analytic</b>	=	<b>4611</b>	425.952
Other social debts and claims		Various debtors	

At the level of Labour and social protection directions are also accounted the operations regarding social benefits found within the accounting of the municipality:

→ showing the payment obligation to municipalities:

<b>671.51.1.36</b>	=	<b>462</b>	254.280
Current transfers between public institutions		Various debtors	

51.1 – the budget classification code for „Transfers between public institutions”

→ the transfer of financial resources to municipalities:

<b>462analytic</b>	=	<b>770.51.1</b>	254.280
Various debtors		Financing from the state budget	

The territorial labour directions fill the accounting information regarding family allowances, particularly on horizontal, meaning in terms of the nature of the reflected benefits and less in terms of the used technical instruments. Because they are government subordinated public institutions, the funds will come from the state budget. It's interesting that for the allowances paid by mail, the use of the funds are highlighted in the same month as the payment obligation. The explanation (at least partial) is the need to observe the principles of the budgetary financing according to which the budget authorization is limited by time and not spending the funds allotted for a certain purpose until the end of the fiscal year will lead to the withdrawal of those funds.

Looking at the way social benefits for families are transposed into accounting we could say that the principles of accrual accounting are not exactly applied in practice. We are especially considering the allowances / indemnities that are given for a period exceeding one year. Their total payment obligation should be acknowledged since the moment it has been generated, meaning the birth of the child or from the moment the child has turned 2/3 years old. Provisions related to the persons who, because of various reasons (death, abandonment of school, etc.), will no longer benefit of these allowances, the indexation of the amount, etc. intervene in the quantification of the debt's value, but for these risks we may turn to an accounting mechanism that is “on hold” – provisions.

We may conclude that transposing into accounting family allowances and the social benefits associated to them is simple and involves: acknowledging the obligation of payment, receiving the financial resources and distributing them to the beneficiaries; the unitary encoding of budgetary revenues and expenditures with the help of the budgetary classification.

## Conclusions

A society is a state, typified by repetition and instructions, sanctioned by rules of constraint and lead by common values.

Although it confronted a series of negative phenomena, the Romanian family found the means to adapt to the economic, social and cultural changes that took place in the last decades.

The evolution of societies was characterized by changes caused by crises rather than by a designed and planned social development [Zamfir and Stanescu (2007)].

Regarding the structure of the forms of social protection for families with children there are no disagreements, but there are conflicting views regarding their size: on one side, some people claim that the government should support the family by granting social benefits as high as possible, others criticize the direction of the government towards establishing and executing budgets for socially assisted people.

Without being one-sided, we believe the “the truth is in the middle”. It can’t be denied that a high quantum of benefits (such as the state allowance for children and not only) may discourage work, but it is also true that “in order to receive, first you have to offer” (jobs, consultancy and solutions for obtaining income, promoting and rigorously supervising the principles of social ethics, non-discriminatory treatments in all the aspects of the social life, etc.).

We believe that the starting point could be to replace the opinions that claim there aren’t enough financial resources with a profound analysis of how public financial resources are used, with the intensification of the measures that generate economic growth (which automatically means a transfer of quality of life). To these we could add a long-term vision regarding the strengthening of social policies and, why not, a different perspective regarding them. As stated by Professor V. Ghețău, in France there is an exceptional policy for the family, but, paradoxically, the largest share is not represented by cash allowances, but are services and benefits for children, day-cares, kindergartens, maternal schools, paid vacations and rent facilities. Furthermore, France is the only country in the world where the tax on wages depends on the number and age of the employee’s children.

Transposing social benefits into current accounting is done at the level of municipalities, but also at the level of Labour and social protection directions. Synthetically, it may be said that accrual accounting in the public sector is limping in terms of the social benefits granted to the family by failing to fully acknowledge the obligation of payment at the time it was generated.

Taking responsibility is a process that depends on several factors: the changes in the value system of the community, the emergence of functional requirements for society, the changes in the system of priorities, the growing ability of institutions to expand their area of responsibility, the emergence of additional resources.

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## AN ISSUE OF CORPORATE GOVERNANCE IN JAPAN: FOR WHOM COMPANIES EXIST?

Yoji Koyama\*

### Abstract

*What is corporate governance? This concept has been interpreted in various ways. In the USA the corporate governance is to subordinate a company's managers to the shareholders' benefit. In contrast, the European type of corporate governance attaches importance to the social value of a company from the standpoint of stakeholders in the wide sense.*

*In this paper I will examine desirable direction of the Japanese type of corporate governance. For that purpose, firstly, specific features and problems of the Japanese style management will be examined. Secondly, introducing opinions of two representative researchers in Japan, problems of the American type of corporate governance will be examined.*

**JEL Classification:** L26, M14, M50.

### I. Introduction

Not so long ago, perhaps in mid 1980s, 'corporate governance' began to be discussed. What is corporate governance? This concept has been interpreted in various ways. In the USA a manager's work in a joint-stock company is to maximize shareholders' economic benefit measured by the shareholders' value. Consequently, the corporate governance is to subordinate a company's managers to the shareholders' benefit. In this way, the American type of corporate governance aims to maximize the shareholders' benefit from the standpoint of shareholders who are stakeholders in the narrow sense (Kakurai, 2005, p.88). Many Japanese people feel that something is wrong with the way of thinking that shareholders should be the almighty in a joint-stock company.

In contrast, the European type of corporate governance attaches importance to the social value of a company from the standpoint of stakeholders in the wide sense. Here the stakeholders include not only shareholders of the company but also creditors, employees and consumers (Ibid., pp.93-94). However, if many stakeholders inside and outside a company are included in the persons concerned of its corporate governance, it seems to be too wide to clarify the problem.

Indeed, without capital any companies cannot be established. But it is sure that without daily labors and efforts of workers who work at the companies they will never operate and develop. How should we understand the problem? In this paper<sup>1</sup> I

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will examine desirable direction of the Japanese type of corporate governance. For that purpose, firstly, specific features and problems of the Japanese style management will be examined. Secondly, introducing opinions of two representative researchers in Japan, problems of the American type of corporate governance will be examined. Finally, conclusion will be drawn.

## **II. Japanese Style Management**

Positive evaluation of Japanese style management has been prevalent in the world in the 1980s and early 1990s, reflecting high economic growth in Japan. At that time many people say as follows: In US enterprises shareholders' voice is so strong that share prices and distribution of dividend have been given priority in enterprises' management. Enterprises performance measured in every quarter has been attached importance. Therefore, the top management apt to manage their enterprises in short-run perspective. In contrast, in the case of Japanese enterprises the top management manage their enterprises in long-run perspective. They tend to distribute a low dividend, but instead they tend to increase investment, giving priority to growth. Such a behavior is consistent with their shareholders' interest.

Japanese style management consists of three pillars: Seniority system; Life-long employment; and Company-wide trade union. These pillars have contributed to loyalty of employees to their companies. However, this can be applied only to big companies.

According to Iwai (2003), characteristics of Japanese companies can be summarized as follows:

(1) Compared with Europe and the USA, shareholder in most of Japanese companies have weaker voice and they can hardly put a word in companies' management;

(2) In most of Japanese companies the top management (executives) has been chosen among employees through the competition for promotion within a company organization. They are running their company with expansion of company itself being as their target rather than the profit rate;

(3) Employees, not all but the core, of Japanese companies have been protected by Life-long employment system, seniority wage system and company-wide trade union, and therefore, they have a strong sense of belonging to their companies;

(4) In places of work in production, distribution and development of products in Japanese companies they attach importance to the informal relationship among employees who share information;

(5) Many Japanese companies have organized themselves into several groups, and they have cross share-holding and maintain horizontal 'keiretsu' relationship for a long-term;

(6) Many Japanese companies have maintained vertical 'keiretsu' relationship for a long-term with themselves on the top and with sub contractors and sub-sub contractors;

(7) Many Japanese companies are financing their funds from the main banks which they have been maintaining a long-term financial relationship (Iwai, 2003).

Japan has experienced the so-called a bubble economy due to high growth rate with speculation in real estates after the Plaza Accord in 1985. The bubble has burst in 1991. As a result the banking sector had a huge amount of bad loans. The solution of this problem has prolonged, and with this the Japanese economy stagnated in the 1990s, which was called a lost decade. Hence appeared negative evaluation of Japanese style management at home and abroad. In Japan there are researchers who have pointed out problems of Japanese enterprises since a long time ago. Among them Hiroshi Okumura, the author of a famous book *Corporate Capitalism: 'Company-centered System'*, criticizes defects of Japanese enterprises system. In his opinion, as for the relationship between a company and its employees, 'Japanese style management' has been in fact a 'company-centered' system. The relationship between a company and its shareholders has been also in fact a 'company-centered' system. Based on such a 'company-centered' system, managers represent the company, and they never represent its shareholders nor its employees. It is managers who represent 'the company itself' and as persons represent the company (Okumura, 1984, p.34).

According to him, it is the first half of the 1950s that concentration of shares in hands of corporations showed a noticeable increase for the first time. At that time the restriction on possession of shares by financial institutions and business corporations was eased owing to a revision of the anti-monopoly law, and with this as a trigger, concentration of shares in hands of corporations occurred. At this stage the reorganization of Zaibatsu to enterprise groups proceeded on the one hand, and the grouping of enterprises (= to organize a keiretsu) by big companies proceeded on the other hand. The concentration of shares at the second stage occurred from the second half of the 1960s through the 1970s. In response to the liberalization of capitals, 'organization of stable shareholders' was pursued as its countermeasure. As a result, cross-share holding ('mochiai') by corporations has proceeded, and the percentage of individual shareholders in the total shares has become very small (pp.53-61). Managers became able to manage their enterprises without minding shareholders' interest. A dividend has been usually very small and it has been often even lower than interest rate (Ibid., p.68).

Who decides managers? According to the Commercial Code, it is the shareholders' general meeting that elects directors and internal auditors. A representative director (= 'Shacho') is to be elected among directors. In most cases, however, shareholders' general meeting is held with cartes blanches of corporate shareholders, and candidates of directors and internal auditors proposed by the company are usually approved as they are (Ibid., p.163). Consequently, in Japanese big companies, as a matter of fact, the president (representative director) decides directors, and when he retires he nominates his successor. Internal auditor is a position for a person who is unable to become a director and the second highest position that he can attain within the company. Therefore, it is impossible to expect that internal auditors can check managers' deviant behavior.

There have been many serious scandals. Here I will introduce two typical cases which occurred in recent years:

- Case of Kanebo. A long time ago the company was a famous textile company and later became a diversified company with a cosmetic department and some other departments. Although the company fell into a situation in which its debt exceeded its capital since several years ago, the top management continued to announce falsified profit and distribute dividend every year by window-dressing. At last three years ago the real situation was brought to light, and the company went bankrupt. Chuo Aoyama, one of the four major audit corporations in Japan, was cooperating with Kanebo's window-dressing, and this audit corporation was severely criticized and was obliged to be dissolved later.

- Case of Mitsubishi Automobile Co. Since a long time ago the company has avoided the recall of cars when troubles occurred with cars and dealt with troubles separately. Therefore, the company has been often criticized for its corporate culture giving profit priority over safety. At last in 2002 a serious accident occurred where a tire, which was dislocated from a truck's axle due to a badly adjusted hub, hit a mother and her child walking along a sidewalk and the mother died instantly. This affair became an object of public concern. The top management of Mitsubishi Fusoh, which used to be the Truck branch of Mitsubishi Automobile Co. and became independent a few years ago, was forced to resign.

It is certain that Japanese enterprises are now urged to change themselves. In order to correct such a situation revisions of laws have been repeated in recent years. For example, the Commercial Code has been undergone minor revisions for more than 10 times during past 5 years. The whole Commercial Law and the Corporate Law were changed in 2005. The revised Commercial Code, which came into effect in 2003, allows major companies to adopt the form 'companies with committee system'. I would like to add that here a major company in the Commercial Code denotes a company capitalized at 500 million yen or a company with its total debts of more than 20 billion yen (Kakurai, 2005, p.98). In this type of company the role of board of directors has changed from management into supervision. Executive officers are no longer members of the board of directors. Instead, many outside directors, who should reflect shareholders' interest, are introduced to the board. The board of directors has three committees; Nomination Committee; Compensation Committee; and Auditing Committee. The board of directors choose CEO (Chief Executive Officer) (Yamada, 2004, p.110).

In the case of SONY outside directors hold the majority in its board of directors. Major companies such as Hitachi, Ltd., and Toshiba transformed themselves into 'companies with committee system'. As of 2005, the number of 'companies with committee' system exceeded 100 (Kakurai, 2005, p.99)

Recently in Japan a new social phenomenon has emerged which reminds us an American way of business. A typical case is that of Mr. Hirofumi Horie. He was an owner of an IT related company (Live Door) and other companies. He left the University of Tokyo halfway and dedicated himself to IT business. His controversial

opinion: “In this world there is nothing which cannot be bought with money” repelled older generations. Younger generation rather welcomed him. Two years ago young as he was (32 years old at that time), he tried to acquire a TV company. He run the general election in September 2005. He was defeated but was warmly received by younger generations. He became a hero of the time. In January 2006 year, however, he was arrested for violation of the Law on Securities Exchange, and was brought to trial. In March 2007 he was sentenced to two and a half years’ penal servitude.

Cases of adversary takeover of enterprises have been very rare in Japan. In recent years, however, the situation has changed. A noteworthy case is Bulldog Sauce Company (BSC), a Japanese food company, vs. Steel Partners (SP) an American investment fund. It became known in 2002 that SP owned shares of the BSC, but there has been almost no contact from the former. Suddenly in May 2007 SP jumped into the largest shareholder with 10.52% of the total shares and offered take-over bid (TOB) with the aim to obtain all the shares. In order to counter this move, BSC adopted a poison pill, to put it concretely, the company planned to decrease the percentage of the shares held by SP through the distribution of reservation right for new shares free of charge. SP applied for a provisional injunction against the resolution of BSC’s shareholders’ meeting. This case went up to the Supreme Court. A petty bench of the Supreme Court judged that the distribution by BSC of reservation right for new shares free of charge does not contravene the purpose of the principle shareholders’ equality, and rejected SP’s application. BSC won the case, but it was obliged to spend a huge amount of money for trial-related expenditures and the payment to SP.

This case tells us that in Japan many people have feeling of wrongness in investment funds from foreign countries which loudly demand Japanese companies to increase dividend, giving shareholders’ short-term benefit priority over the companies’ long-term benefit. Mr. Warren Lichtenstein, President of SP, said that he is not interested in a taste of the sauce, but he requested a change in the top management of the company. And he said, “I want to enlighten managers of Japanese companies and Japanese investors”. Such an arrogant speech offended many people in Japan.

Will Japanese enterprises be approaching toward the type of American enterprises hereafter? In my opinion, that is not likely to occur. Firstly because in Japanese society the tradition of “productivism” remains as Ronald Dore (2001) points out, and therefore many people are reluctant to play money games. Secondly because American type of corporate governance has serious defects. Below I will introduce arguments of two distinguished researchers in Japan: Hiroyuki Itami, Professor at the Hitotsubashi University, a specialist on Business Administration, and Katsuhito Iwai, Professor at the University of Tokyo, a specialist on Theoretical Economics. Professor Itami lays emphasis on differences in culture and tradition. Professor Iwai finds out a theoretical error in the American type of corporate governance.

### III. Professor Itami's argument

Itami defines corporate governance as follows: Exercise of influence on the management by 'people possessing citizenship' in an enterprise in order for the enterprise to continue showing its desirable performance (Itami, 2000, p.17). According to him, "Corporate governance is different from the management of an enterprise. The management of an enterprise is done by the managerial strata including the top management and it means the controlling action of business activities. The people possessing citizenship in an enterprise entrusts the controlling action to the managerial strata. ... Check on managerial strata, managers in particular, is corporate governance" (Ibid., p.18).

The problem is how to comprehend 'people possessing citizenship' in an enterprise. The current Corporate Law prescribes that sovereign in an enterprise is its shareholders. However, Itami stresses that the Corporate Law is not a law which explicitly prescribes the relationship of rights and duties between people working in a company and its shareholders. He says, the Corporate Law is a law which prescribes the relationship of rights and duties between providers of stock capital and debtors within (and only within) the people who provided funds. He adds, an argument that Japan has a legal system of shareholders' sovereignty and, therefore, employees' sovereignty is against the law on the ground of the Corporate Law does not hold good (Ibid., pp.84-85).

According to Itami, in Japan a generally accepted notion among people working in enterprises, especially big enterprises is that a company belongs to the people who work there (p.59). Corporate governance of Japanese enterprises is shareholders' sovereignty in "tatemae" (a stated principle), but it is employees' sovereignty in "hon'ne" (reality) (pp.49-50). Here employees' sovereignty of Japanese enterprises means that employees' sovereignty has primacy with shareholders' sovereignty being secondary (p.59). However, it is noteworthy that in Japan usually managers have been chosen among ordinary employees who have competed for promotion within a company. Therefore, Itami includes also managers in a group of employees in this case. Namely, he uses a category of employee in a wider sense. In addition, he classifies the employees into several groups. Not all employees are equally substantial 'sovereign'. There is a group of employees who commit themselves to the company for a long time and can be called a core member. People who belong to this group are substantially sovereign. Part-time workers and workers who do not intend to work in a company for a long time are excluded (Ibid., p.60).

Itami explains enterprises with employees' sovereignty by his unique concept 'Jinponshugi' (Human capitalism). One of his main works is *Jinponshugi Kigyō [Human Capitalist Enterprises]*, published in 1987. 'Jinponshugi' is a word coined by Itami. He extracted it as "a principle that has existed behind the customary practice of management which most of the postwar Japanese enterprises have half tacitly done (Itami, 2000, p.70).

In his opinion, principle of management and its institution can be formulated in

the following way: Institution (System) = Environment  $\times$  Principle (Itami, 1987, p.20) . Later readers will be able to understand more concretely.

According to him, the enterprise system has the following three elements: (1) Concept of enterprise: to whom an enterprise belongs?; (2) Concept of sharing. This is his unique idea. Readers might confuse it with companies' share (stocks), but it is quite different from that. The concept of sharing relates to who share what and get share of what?; and (3) Concept of market: how are enterprises connected with one another? (Ibid., p.31). He compares Human-capitalism and Capitalism (Table 1).

**Table 1. Human-capitalism vs. Capitalism**

	Human-capitalism	Capitalism
1. Concept of enterprise	Sovereignty in employees	Sovereignty in shareholders
2. Concept of sharing	Dispersed sharing	Unified sharing
3. Concept of market	Organized markets	Free markets

Source: Ibid., p.37.

According to him, behind the difference between Capitalism and Human-capitalism there are different views on enterprises and people. There are three views of enterprises. Activities of enterprises are classified into the following three types: 1) Collective of activities of material transformation; 2) Collective of information processing and learning; and 3) Collective of psychological reaction of enterprises' member. In capitalist enterprise system there is stratification of three views of enterprises. At the bottom there is a view of materials. People are grasped as things. In order to make the things function a view of information becomes necessary. Then psychological aspect of human beings should be considered as an element which affects the information activity. In contrast, in human-capitalist enterprise system the three views of enterprises exist on equal footings or as a total behind the system. There is no stratification of the three views, or weak stratification if any. An enterprise is grasped as a collective of human beings. Human beings as physical substance, human beings as informational substance and human beings as psychological substance are all explicitly taken into consideration (Ibid., p.51)

Why was it born in Japan? Was it due to its culture or the epoch? According to Itami, prewar society of Japanese enterprises was much more capitalistic than now. Itami presents the following hypothesis: If we distinguish a principle from an institution in our consideration, the principle of human-capitalism is not bound by the Japanese culture, but it is most likely that the institution as receptacle, which has supported the principle during the post-war period, has been affected by the Japanese culture (Ibid., p.60).

**Table 2 Differences in Competition between Human-capitalism and Capitalism**

Human-capitalism	Capitalism
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Competition in the long run	Competition in the short run
Competition with visible face	Competition with anonymity
Multi-dimensional competition	Mono-dimensional competition
Competition among groups	Competition among individuals

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Source: *Ibid.*, pp.53-54.

Itami explains the biggest reason why has such common principle emerged. He lays an emphasis on the circumstances in which the postwar Japan was placed. The situation such as disorder, critical situation and burst of people's energies for democracy gave rise to a quite democratic and new enterprise system like the human-capitalist enterprises system (*Ibid.*, p.61). He describes the situation in Japan immediately after the war: Quite a large-scale of democratic reform was enforced by the Occupational Army. Activities for democratization were pursued by managers, for example, Keizai Doyu Kai (an association of managers) with Mr. Kazutaka Kikawada as a central figure. At the same time, many trade unions were newly formed. In miserable economic situation industrial strife often occurred. The experience of the strife in such an extreme situation led to perception that simple repetition of selfish behavior and conflicts of interests would result in ruin of enterprises themselves and loss of livelihood of all the working people.

Due to dissolution of Zaibatsu, the so-called "capitalists" have quickly disappeared from Japan and only managers and workers have remained as the persons actively concerned. In addition, most of managers from the prewar period were expelled due to the political purge. As a result, in many enterprises newly inaugurated managers were people who had taken pains close to production processes as middle-ranking executives until yesterday. They were fellows in the production processes.

Itami (2000) writes about activities for democratization pursued by managers. In his book Itami introduces an important material which he recently found among old documents. It is Draft Plan of Democratization of Enterprises, published in September 1947. He quotes an essential part from the Draft Plan, which says: "It is our principle that an enterprise is a cooperative society composed by management, capital and labor. ... The absolute relationship of the shareholders to the enterprise shall be changed. ...". It is very impressive that such a radical statement was announced not by leaders of trade unions but by managers of companies. Its central figure was Mr. Banjo Ohtsuka (President of the Nihon Special Steel Pipe Company). By the way, also Kakurai (2005) mentions Mr. Banjo Ohtsuka (p.155).

According to Itami, quite naturally, perception that an enterprise belongs to working people has emerged in such a situation. It is a natural discussion that sharing in enterprise shall be dispersed democratically. Every enterprise is together with its business partners in the same boat, and therefore, they cannot survive unless they cooperate with one another. An era has come when the principle of human-capitalist system can be implicitly shared (Itami, 1987, p.62). Taking this context into mind, readers will be able to understand Itami's following formula: Institution of Japanese

style management = Principle of human-capitalism × Environment of the postwar Japan (Ibid., p.64).

**Table 3 Strength and weakness of Human-Capitalist System**

Strengths:	Weaknesses
Sovereignty resides in employees. Persons worthy of sovereign are working people. Employees sovereignty is more efficient than shareholders sovereignty in the two points:	Weak check of mismanagement
1. a community of interests	Shareholders' meeting has been reduced to a shell, only a ceremony.
2. informational efficiency of decision-making	
It is easy for employees to accumulate skills and knowledge effectively.	Internal auditing (by Internal Auditors) does not function well.

Source: Prepared by the author based on Itami (1987) and Itami (2000).

Human-capitalism has strengths and weaknesses as shown by Table 3. Of course, Japanese enterprises must overcome such weaknesses while preserving their strengths. These are future challenges for corporate governance in Japan

By the way, what will become of shareholders? On this point Itami says as follows: People who provide a company with money do not work in the company. Nor they are persons who take part in activities in the company and receive satisfaction from the work in any forms. Basically, they are persons who aim to get returns on the investment. It would be the most suitable that shareholders would not become almighty sovereign, but silent partner with the last voice (2000, p.148).

#### IV. Iwai's argument

Iwai defines corporate governance as follows: "Corporate governance is a problem how to control managers' works in order that joint-stock are efficiently managed"(Iwai, 2003,, p.84). Iwai's main works on corporate governance include: Iwai (2003), *What will become companies hereafter?* ; and Iwai (2005), *For whom companies exist?*. A uniqueness of his arguments is that he attaches importance to the concept 'legal persons'. Naturally, his arguments begin with the concept of 'legal person'.

According to him, legal person has two aspects: persons and at the same time things. A company as a legal person can conclude a contract with other company. A company can sue (an) individual(s) or other company. Shareholders are not owners of assets of company. They own a 'company as a thing'. A 'company as a thing' is not a thing which has a concrete form. It is, in fact, abstract things called stacks or shares. Shareholders are literally none other than holders of shares (Iwai, 2003,

pp.48-50).

In order for a company as legal person to conduct its managerial activity in society, it absolutely needs a living person who actually make use of funds and concludes contracts with others in the name of the company. A person who conducts management for and in place of the company is called “representative director” (Daihyo Torishimariyaku & Shacho). In case of foundation like a museum, a trustee (Riji) does that (Ibid., p.77) .

A representative director is an organ. A representative organ such as representative director or trustee is an entity which substitutes for organ like a brain, ears, a mouth, and hands and legs of a legal person. Thereby the organ makes a legal person behave in the real society as if it is a person with flesh and blood. He is like a puppet manipulator in Ningyo Joruri, a Japanese puppet show. An important point is that manager(s) is (are) absolutely necessary for a joint-stock company. Without manager(s), a joint stock-company can never function as a person in the real society (Ibid., pp.77-78).

If a manager is not an agent of the shareholders on the basis of a contract of commission, what is he? He is “a person entrusted fiduciary” (simply called a fiduciary). Fiduciary is a quite different concept from contract. For example, it is a relationship between a sick person in unconsciousness and a medical doctor who operates the former. Relationship between persons like infants, mentally handicapped persons or senile persons who cannot, de jure or de facto, conclude a contract, and guardians who manage property on behalf of them. Jobs of experts with highly professional expertise such as lawyer, engineer, teacher, accountant, fund manager do for others are based on fiduciary, even if they conclude contracts. Because there is a big difference in knowledge and ability between them and their clients (Ibid., pp.81-82).

An organ which represents a legal person like a manager of a company or trustee of a foundation is also placed in a relationship of fiduciary with these legal persons. Legal persons are honorable person in contracts like a sick person in unconsciousness who is conveyed to an emergency hospital, but they have in reality no ability to conclude contracts. A legal person’s representative organ which expresses the will and acts on behalf of the legal person is necessarily a fiduciary of the legal person (Ibid., pp.82-83).

**Table 4 Comparison between a Classic Enterprises and a Joint-stock Company**

Classic (Individual or joint) enterprise	Joint-stock company
Managers do not necessarily exist. An owner is the manager. Even if there is a manager other than an owner, the manager is only a person who is entrusted to manage by the owner on the latter's own responsibility. The manager is an agent of the owner. Their relationship is voluntary proxy. A contract of commission is concluded between the both	A manager exists not because he has a contract with shareholders, but because the Company Law prescribes that companies should have their managers.

Source: Ibid., p.79.

Any contracts concluded among persons concerned in the relationship of fiduciary become basically a 'self-contract' of the fiduciary. It is a fundamental principle that a self-contract is invalid as a contract. Fiduciary obligation includes the following points: (1) A fiduciary should do his job not for his own interest, but do his job faithfully only for the partner of the fiduciary relationship (obligation of faithfulness); (2) A fiduciary is obliged to do his job with usual carefulness which is required in each position (obligation of carefulness). The fiduciary obligation is a 'compulsory regulation', which take precedence over contracts as 'voluntary regulations' (Ibid, pp.85-88).

Barle and Means (1932) pointed out that the phenomenon 'separation of ownership and management' has become prevalent in modern joint-stock companies. Since then, a problem has raised how to regain shareholder's sovereignty and make professional managers act faithfully for the shareholders' interest. The corporate governance system in the USA has drastically changed in response to the tendency of laissez-faire which spread since the second half of 1970s and the emergence of the Reagan Administration (1980). In 1980s it became very popular that a stock option is used as a kind of remuneration to managers (executives). Stock option is 'right to buy stocks (shares) from the company at a predetermined price at designated time in future (Iwai, 2003, pp.89-90).

Iwai introduces a discussion in the USA. A method to regain shareholders' sovereignty is to abolish the separation of ownership and management. If their manager becomes a shareholder, "shareholders' sovereignty" will automatically revive. At least, if the remuneration of manager is connected with the price of the company's shares, then his pursuit for his own interest will simply lead to the interests of shareholders. If a manager receives the remuneration especially in the form of stock option, he will wholeheartedly endeavor to increase the price of the company's shares (Ibid., pp.91-92).

Iwai says, the American system, which has liberated managers from ethics,

neglects the fact that there is essential difference between governance of classic enterprises and governance of joint-stock companies and makes a theoretical error (Ibid., p.95). He says the reason as follows: In the case of a classic enterprise, a manager is an agent of the owner. The owner concludes a contract with a manager of his own accord. He can include whatever clause in the contract. However, in the case of governance of a joint-stock company, i.e., corporate governance, circumstances are quite different. A manager of a joint-stock company is not an agent of shareholders, but a representative organ of the company. Whatever contract a joint-stock company concludes can be concluded only through its manager. Consequently, any contracts concluded between a company and its manager would necessarily become a self-contract of the manager. If a manager is thinking only about pursuit for self-interest, it would be possible for him to make out whatever contract convenient for him. Therefore, managers' behavior in joint-stock companies is required a kind of ethics. Recently in the USA increasingly many companies pay their managers remuneration in the form of a bonus connected with the stock price or stock option. In this point self-contracts by managers are suspected<sup>2</sup> (Ibid., pp.95-96).

Its consequence is clear. A big difference in remuneration has emerged between a president of company and an employee. The average difference in Japan is 12 times. In contrast, in the USA the difference increased from 85 times in 1990 to 531 times in 2000. One of the worst case is the scandal of the Enron (Ibid., pp.92-94).

It is well known that there have been differences between laws and practices. Iwai explains the differences in the following way: According to the Corporate Law, for example, employees are persons outside a company. They are only persons who concluded contracts of employment with a company as legal person. In that sense, they have no difference from suppliers of raw materials, buyers of products and financial institution. Here is a paradox: In Japan an employee of a company is usually called 'shain', which literally means a staff member of a company. In the Corporate Law the word 'shain' denotes a shareholder, who is really an owner of the company. Traditional economics have been treating employees as persons outside the

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<sup>2</sup> Itami (2000) is also very critical about stock option for the following reasons: First, stock option as an incentive for a manager is a device which might lead to fraudulence. A manager gets a right to buy his own company's shares at a low price. When the share price becomes higher he exercises his right and buys the shares at a lower price. If he sells the shares then capital gain immediately emerges, and he can obtain it as a cash income. The cash income is remuneration which he received directly from the company but he received from a man who has newly become a shareholder. In other words, stock option has a quite different way of thinking from profit sharing in which a company rewards its shareholders from earnings that it really accomplished, but stock option aims to reward a manager by an income transferred from an investor in a stock market. A manager who earned money is a person who enjoys a wide-ranging power of decision-making which affects the price of the company's share. There is a too big difference in information between a new shareholder who buys the share that the manager sells and the manager himself. Here, in a nutshell, is a source of fraudulence which might lead to a variant of insider trading. Second, although stock option is given allegedly for shareholders' sake, it contains danger of an excessive income of a manager (pp.341-343).

companies and only suppliers of labor services. However, Japanese ‘salary man’ (a Japanese expression which actually denotes an ordinary employee) identifies himself with his company. The consciousness of representative organs of the companies spread at least partially to common members of the companies, who are only employees de jure. As the case may be, such consciousness reaches blue color workers. Why? Because they are persons who invest in ‘organization-specific human resources’. In the era of post-industrial society, investment in human assets (i.e., brain) becomes increasingly more important. In this way, Iwai points out the limit of the present legal framework of joint-stock companies.

## V. Conclusion

Certainly, there are problems in the present situation of corporate governance in Japan. A change in corporate governance in Japan is inevitable. Corporate governance must be more transparent. However, it will not be the American type of corporate governance that companies in Japan should aim at.

Problems that the American type of corporate governance involves were clarified from discussions of two representative Professors in Japan. Using his unique expression ‘Human-capitalism’, Itami argues positive aspects of the Japanese enterprise system. After explaining his formula that an institution is a product of a principle and an environment, he argues that the Japanese type management has emerged in a special situation in which Japan was placed immediately after the war. It is evident from his formula that with a change in the environment accordingly the institution should change. According to him, even if a concrete institution changes ‘human-capitalism’ as a principle remains unchanged. He criticizes an opinion which has been prevalent in the USA that shareholders should be the almighty. I think that his criticism deserves attention. However, it would be better for us to take ‘human-capitalism’ as a kind of ideal type. In reality, there are many companies whose behavior contradicts the principle of ‘human-capitalism’. If all the companies in Japan behave like ‘human-capitalist enterprise’, phenomena such as ‘karosh’ (death from overwork) should have never occurred.

Iwai argues what joint-stock companies ought to be on the basis of a concept ‘legal person’. According to Iwai, a representative director is an organ of a joint-stock company, and he/she is a fiduciary of the joint-stock company. From his standpoint, a popular way that managers receive their remuneration in the form of a bonus connected with the stock price or stock option in the USA means a self-contract, i.e., a kind of prohibited technique.

He criticizes the American type of corporate governance in which shareholders are the almighty on the ground that investment in human capital will become increasingly more important in post-industrial society. Although different in their approaches, his argument in this point has something in common with Itami’s following argument: The original source of enterprises’ competitiveness is the enterprises’ ability of technological transformation and its efficiency. The ability

derives from invisible assets which the enterprises have accumulated such as technology, know-how, trustworthiness, etc. Such invisible assets cannot be bought with money. Enterprises need to accumulate in these assets by themselves. It takes time to produce them. Once accumulated, however, they can be used in multiple ways. These assets have such specific features (Itami, 2000, p.96). I think that investment in human capital or invisible assets is one of key issues when we consider corporate governance.

Japanese type of corporate governance will gradually change in the future, but its basic features will remain<sup>3</sup>.

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<sup>3</sup> Nobuo Takahashi, Professor at the University of Tokyo, a specialist of managerial organization stresses the importance of Japanese style of seniority system and severely criticizes 'Seikashugi' (system which differentiates employees according to their results). He argues as follows: People will not work hard by 'Seikashugi'. Make a job itself worthwhile. Japanese style of seniority system is, in essence, not a system which rewards by salary but a system which rewards by the content of next job. Try to build environment of Japanese style seniority system where the young are engrossed in their works without anxiety of daily lives. Takahashi (2004a) and Takahashi (200b).

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**BONDS RECOVERY FROM THE ECONOMIC AGENTS BY THE UNIFICATION OF THE EUROPEAN LEGISLATION REGARDING THE PERFORMANCE OF THE COURT JUDGEMENTS DELIVERED IN THE EUROPEAN UNION STATES AND IN THE EUROPEAN ECONOMIC AREA**

*George Măgureanu\**

**Abstract**

*A large number of litigations between the economic agents, in our country and abroad, are to be solved at a rapid pace and also bonds recovery to debtors. In this way, the European Union Regulation allowed the release of binding securities which are valid in all European economic area, without the necessity for them to be acknowledged and approved by the state where forced performance is applied for.*

**Keywords** – economic agents, judgment, European binding security, forced performance, creditor, debtor.

**JEL Classification:** K22, K40

As long as the multitude of domestic and foreign trade relationships engenders countless litigations which have to be solved reasonably to restore the rights infringed, the acceleration and simplification of the procedure of performing the judgements delivered in other member state than the one where the judgement was delivered, by eliminating all the intermediary measures which are taken before the performance in the state where this is applied for, as a necessity of the effective performance of the petitioners' claims which have proved to be true, irrespective of the country of origin, constitutes a necessity of our present time<sup>1</sup>.

Setting up a free area of security and justice in the European Union required,

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<sup>1</sup> A large number of works in the field deal with the topic of performing the national and international judgements. We recommend several of them, among which: S. Zilberstein, V.M. Ciobanu, *Drept procesual civil. Executarea silită*, vol. I și II, Ed. Lumina Lex, Bucharest, 1996; Fl. Măgureanu, *Drept procesual civil*, XIth edition, Universul Juridic Publishing House, Bucharest, 2009, p. 558 and the next ones; D. Negulescu, *Execuțiunea silită, Principiile generale*, vol. I, Tipografia Guttenberg, Bucharest, 1910; E. Herovanu, *Teoria executării silite*, Cioflec Publishing House, Bucharest, 1942; I. Stoenescu, A. Hilsenrad, S. Zilberstein, *Tratat teoretic și practic de procedură a executării silite*, Academiei Publishing House, Bucharest, 1966; C. Sion, *Căile de execuție*, Iași, 1943; I. Stoenescu, S. Zilberstein, *Tratat de drept procesual civil*, vol. II, Universitatea Bucharest, 1981, p. 207 and the next ones; E. Dan, *Codul de procedură civilă adnotat*, Bucharest, 1921, p. 537 and the next ones; V. Negru, D. Radu, *Drept procesual civil, E.D.P.*, Bucharest, 1972; G. Boroș, D. Rădescu, *Codul de procedură civilă comentat și adnotat*, All Publishing House, Bucharest, 1994, p. 637 and the next ones.

among other things besides Romania's accession to the European Union, the adoption of appropriate measures in the field of judiciary cooperation in civil and commercial matters, necessary measures for the good functioning of the domestic market, including the forced performance of the judgements and of the binding securities.

In the European Union creating a more refined and rapid procedure for recovering the bonds from debtors which, although going through all the stages of the court procedure, refused to willingly perform the final and irrevocable judgements.

As a consequence, in November 2000, the European Council adopted a program concerning the application measures of the principle of mutual acknowledgement of civil and commercial judgements<sup>2</sup>, after which, beforehand, on 3rd December 1998, the Council adopted a plan of action for the Council and the Commission on the optimal rules of applying the provisions of the Treaty of Amsterdam regarding setting up a free area of security and justice (the Vienna Action Plan).

They adopted dispositions which might unify the rules regarding the conflicts of competence in civil and commercial matters and the simplification of the formalities with a view to rapid and simple acknowledging and performing judgements by the member states, when the judgements are delivered in a state and its performance is required in another state of the European Union or of the European economic area.

Law no. 191 of 19/06/2007<sup>3</sup> for the approval of the Government Emergency Ordinance no. 119/2006 regarding the necessary measures for applying some communitarian regulations on the date of Romania's accession to the European Union, provided regulations regarding the application of the Regulation (CE) no. 805/2004 of the European Parliament and of the Council from 21st April 2004 regarding the creation of a European binding security for the certified<sup>4</sup> bonds, regulation adopted in Strasbourg on 21st April 2004.

The provisions of this Regulation are obligatory for Romania as well, its dispositions provided are also obligatory as a whole their application is a prior to the

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<sup>2</sup> See the European Parliament Notice of 8th April 2003 (JO C 64 E, 12.3.2004, p. 79), Common Position of the Council from 6.2.2004 (not published in the Official Journal) and European Parliament Position from 30.3.2004 (not published in the Official Journal).

<sup>3</sup> Law no. 191/2007 from 19/06/2007 for the approval of the Government Emergency Ordinance no. 119/2006 regarding some measures necessary for the application of communitarian regulations on the date of Romania's accession to the European Union, was published in the Official Journal, Part I no. 425 from 26/06/2007. See also the Emergency Ordinance no. 119/2006 from 21/12/2006, published in the Official Journal, Part I no. 1036 from 28/12/2006.

<sup>4</sup> See: Regulation (CE) no. 805/2004 of the European Parliament and Council from 21st April 2004 regarding the creation of a European binding security for certified bonds and the Council Regulation (CE) no. 44/2001 from 22nd December 2000 regarding the competence, the acknowledgement and the performance of judgements in civil and commercial matters. See also the changes made to the Regulation by the Regulation (CE) no. 1496/2002 of the Commission (JO L 225, 22.8.2002, p. 13).

national legislation. By „judgement”, as to its meaning in the Regulation, we understand any decision delivered by a court in a member state, irrespective of its denomination as „decision”, „sentence”, „ordinance” or „binding decision”<sup>5</sup>.

The Regulation no. 805/2004 of the European Parliament and the Council<sup>6</sup> applies in civil and commercial matters, in, respectively:

- court decisions;
- judiciary transactions;
- authentic documents regarding certified bonds,
- judgements delivered as a result of the procedures against court decisions.

The Regulation does not apply in:

- fiscal, custom or administrative areas, neither regarding the state responsibility for acts or omissions committed while exercising public authority („*acta jure imperii*”);
- the state of the capacity of natural persons, matrimonial regimes, testaments or successions;
- the bankruptcy of arrangements or other similar procedures;
- social security;
- arbitration (art. 2 align. (2) of the Regulation no. 805/2004).

It is considered a certified bond:

- when the debtor acknowledged it expressly accepting it or appealing to a transaction which was approved by a court or concluded in front of a court during the court procedure;
- when the debtor was never against it, according the procedural rules of the member state of origin, during the court procedure;
- when the debtor was absent or was not represented in a court session regarding this bond after he opposed it initially during the court procedure, as long as his attitude is similar to a silent acknowledgement of the bond or of the facts stated by the creditor based on the legislation of the member state of origin;
- when the debtor certified it expressly by an authentic document.

The lack of objections from the debtor can be represented by the absence from the court session or the fact that he did not perform an invitation by the court to notify in writing his intention to defend himself in the respective case, although the summon procedure and the procedure of handing in the procedural documents was legally fulfilled.

Mutual trust in the administration of justice in member states makes it possible that the court in a member state considers that all terms for certifying a European binding security are met to allow the performance of the judgement in all other member states, without a judiciary control of the correct application of the minimal standards of procedure in the member state where the decision has to be performed.

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<sup>5</sup> In Sweden, in brief procedures regarding payment orders (betalningsföreläggande), the term „court instances” includes the Swedish public service for forced performance (kronofogdemyndighet).

<sup>6</sup> For applying the regulation, see also the Decision 1999/468/CE of the Council from 28th June 1999 of establishing the procedures for exercising the competences of performance granted to the Commission (JO L 184, 17.7.1999, p. 23).

They considered that a judgement which was certified as a European binding security by the court of origin should be treated for its performance as if it were delivered by the member state where its performance was required<sup>7</sup>.

In the Regulation already mentioned they tried to ensure the free circulation of judgements, of the judiciary transactions and of the authentic documents in all member states, without the necessity to appeal to an intermediary procedure in the member state where they were performed.

As a result, a judgement which was certified as a European binding security in the member state of origin is acknowledged and performed in the other member states, without the necessity to admit the performance and without the possibility to oppose its acknowledgement, thus eliminating the procedure of the *exequatur*, a procedure which was sometimes really difficult.

For the free circulation of judgements, the judgements delivered in a member state regarding the Regulation already mentioned, judgements have to be acknowledged and executed in another member state, even if the debtor against whom the judgement was pronounced resides on the territory of a third state.

In these cases as well the rules of competence have to be provided by a high degree of predictability and be based on the principle according to which competence is, generally, based on the residence of the defendant and has to be always available according this law, except for some well defined situations where the object of the litigation or the autonomy of the parties justifies another factor of connection. For legal persons, the residence has to be independantly defined in order to enhance the transparency of the common rules and eliminating the conflicts of competence.

Except for the defendant's residence, there have to be alternate legal bases for competence according to a tight relationship between the court and the case or for the good administration of justice.

For unitary administration of justice it is necessary to decrease to a minimum the possibility of rivalling cases and eliminating the delivery of incompatible judgements in two member states. There has to be a clear and effective mechanism of resolving the litispentence cases and the collateral cases, as well as of avoiding the issues which result from the national differences regarding the establishment of the date when an case is being judged.

Based on the principle of mutual trust, the procedure according to which a judgement delivered in a member state becomes exectory in another member state has to be rapid and efficient. For this purpose, the statement regarding the binding security of a judgement has to be automatically performed as a result of simply formal verification of the documents provided, without the possibility for the court

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<sup>7</sup> The United Kingdom was given as an example. There the registration of a foreign judgement certified will be done according to the same rules for the registration of a judgement delivered in another region of the United Kingdom and this does not imply a case verification of the foreign judgement.

to assign one of the rules of performance provided by the Regulation.

For certifying a court judgement as a European binding security, the Regulations already mentioned provided the necessity to establish the minimal standards met by the procedure which regulates the way the judgement is delivered in order for the debtor to be informed in due time and so that he could prepare his defense regarding the case against him, regarding the terms of his active participation in the procedure to oppose the respective bond, if he considers it necessary and regarding the consequences of his non participation.

The request for certification as a European binding security for certified bonds is optional for the creditor, who can choose the system of acknowledgement and performance provided by the Regulation (CE) no. 44/2001 or other communitarian instruments<sup>8</sup>.

According to the provisions of art. 5 of the Regulation, a court judgement which was certified as a European binding security in the member state of origin is acknowledged and performed in the other member states, without the necessity to admit its performance and the possibility to oppose its acknowledgement.

To be certified as a European binding security, on the request of the court of origin by the creditor at any time, the judgement regarding the bond certified delivered in a member state, has to fulfil the following conditions i:

- the judgement is executory in the member state of origin;
- the judgement is not compatible with the dispositions in the matter of competence provided by the Regulation (CE) no. 44/2001 chapter II sections 3 and 6;
- the court procedure in the member state of origin met the requirements provided by chapter III in the case of a certified bond according the article 3 alignment (1) letters (b) or (c) of the Regulation;
- the judgement was delivered in the member state where the debtor resides according to article 59 of the Regulation (CE) nr. 44/2001, in case you deal with a certified bond according to the article 3 alignment (1) letters (b) or (c) of the Regulation or in case this relates to a contract concluded by a person, the consumer, for a use which can be considered alien to his professional activity or in case the debtor is the consumer.

If the court judgement comprises an executory decision regarding the court costs, including the interests, this is also certified as a European binding security regarding the costs except the case when during the court procedure the debtor expressly opposed his obligation to support the respective costs, according the legislation of the member state of origin. If the judgement certified as a European binding security ceased to be executory or in the case they suspended or limited its

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<sup>8</sup> For the notification and communication of documents by the procedure provided by the Regulation, see also Regulation (CE) no. 1348/2000 of the Council from 29th mai 2000 regarding the notification and communication in the member states of the in- and extra-court documents in civil and commercial matters.

performance, they deliver a certificate which mentions the suspension or limitation of its executive force, based at any time on a petition to the court of origin.

The competence concerning the certification of binding securities belongs to the first instance in case the binding security is a judgement, including the one which states a judiciary transaction or an agreement of the parties under the legal terms or the court in whose circuit there is the deliverer of the document if the binding security is an authentic document.

The instance pronounces the judgement on the petition for delivering the certificate by concluding, without the parties being summoned.

The conclusion by which the petition was admitted is not liable to undergo any attack procedure, and the conclusion by which the petition was rejected may undergo recourse, within 5 days from its delivery for the current creditor, and from its communication for the creditor who was absent.

The certificate is delivered to the creditor and is communicated in a copy to the debtor.

The certificate of European binding security is delivered using the standard form provided in annex I of the Regulation no. 805/2004. The form is to be filled in the language the judgement is written in.

Based on a petition to the court of origin, the certificate for the European binding security may be corrected in case, as a result of a material error, there is an incompatibility between the judgement and the certificate.

Also it may be withdrawn in case it is obvious that the certificate was illegally delivered, taking into account the requirements provided by the regulation already mentioned.

The delivery of a European binding security may not undergo any attack procedure.

The certificate of the European binding security produces its effects within the binding force of the judgement whose execution is requested.

A judgement may not be certified as a European binding security if the debtor is entitled, on the basis of the legislation of the member state of origin, to require a review of the respective decision, when the following conditions are met:

- the document by which the instance is notified about or an equivalent document, accordingly, the summons was notified or communicated by one of the procedures provided by article 14 of the Regulation and which refers to the non-fulfilment of the terms required by the procedure used for solving and pronouncing the decision whose certification is petitioned for, concerning the debtor's summons;

- the notification or communication was not performed in due time to allow him to prepare his defense, with no fault from his side in this respect;

or

- the debtor was hindered from opposing the bond for reasons of force majeure or as a result of some extraordinary circumstances, without his fault in this respect, provided he performs fast in both cases.

The execution procedures are regulated by the legislation of member state of

execution, without infringing the dispositions of the Regulation already mentioned.

A judgement certified as a European binding security is performed under the same terms as a judgement delivered by the member state of execution.

The creditor is liable to provide for the authorities responsible for the execution in the member state of execution:

- a copy of the judgement, which meets the terms necessary to establish its validity;

- a copy of the certificate of European binding security, which meets terms necessary to establish its validity;

- accordingly, a transcription of the certificate of European binding security or a translation of this one in the official language of the member state of execution or, when the respective member state of execution has several official languages, in the official or in one of the official languages of the judiciary procedure of the area where its execution is required, according the legislation of this member state or in another language that the member state of execution declares it acceptable. Any member state may declare the official language/languages of the institutions of the European Community, other languages apart from its own language/languages which the respective member state consider acceptable for the certificate to be filled in. The translation is certified for conformity by an authorized person in this respect in one of the member states.

Neither a bail nor a warranty, irrespective of its denomination, may be enforced, because of the quality of ressortissant of a third member state or because of lack of residence in the member state of execution of the party who requires the execution in a member state of a judgement certified as European binding security in another member state.

At the debtor's request, the execution is rejected by the competent instance in the member state of execution when the judgement certified as European binding security is incompatible with a previously delivered judgement in any member state or in a third country, if:

- the previous judgement was pronounced between the same parties in a litigation with the same case;

- the previous judgement was pronounced in the member state of execution or it met the terms necessary for its acknowledgement in the member state of execution;

- the incompatibility of the decisions was not and could not have been invoked during the judiciary procedure in the member state of origin.

The judgement or its certification as European binding security may not ever constitute the object of a case review in the member state of execution.

When the debtor:

- filed for a suit against the judgement certified as a European binding security, including a petition for reviewing the meaning of the article 19;

- required the correction or withdrawal of a certificate of European binding security according article 10 of the Regulation, the court or the competent authority

of the member state of execution may, at the debtor's request:

- limit the execution procedure to ensurance measures or
- constrain the execution of setting up a warranty that he establishes or
- in special cases, to pestpone the execution procedure.

The Regulation concerning European binding securities applies to judgements, judiciary transactions approved or concluded and to authentic documents enacted or registered after it enters into force.

Certainly there are also other measures imposed for a an accelerated solution of conflicts between the traders in the European Union, such as the precautionary arrangement, the ad-hoc<sup>9</sup> mandate etc., which might hinder the insolvency of the companies in financial difficulties, if these can rise by reorganizing themselves.

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<sup>9</sup> Law no. 381/2009 regarding the introduction of the precautionary arrangement and the ad-hoc mandate, was published in the Official Journal, Part I no. 870 from 14 December 2009 and entered into force on 13th January 2010.

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## HUMAN RESOURCES MANAGEMENT AND THE COMPANY'S INNOVATION

*Marius-Dan Dalotă and Alexandra Perju\**

### **Abstract**

*This paper analyses the relationship between innovation and human resource management (HRM), attempting to establish whether innovation determines the company's human resource management or, conversely, human resource management influences the level of innovation of the company. Based on this review, some research hypotheses are formulated. The results mentioned in the present paper provide evidence that, in order to affect employee behaviour, the firms must develop a bundle of internally consistent HRM practices.*

**Keywords:** innovation; small and medium-sized enterprises; human resource management;

**JEL Classification:** L26, M12, M50

### **1. Introduction**

Innovation and human resources management play an increasingly important role in sustaining "leading edge" competitiveness for organisations in times of rapid change and increased competition. "Discontinuous change requires discontinuous thinking. If the new way of things is going to be different from the old, not just an improvement on it, then we need to look at everything in a new way".

The continuous hegemony of innovation and creativity arises from organisations recognising that correctly harnessed creativity can offer companies a competitive advantage (Porter, 1980). The analysis of the strategies of the top companies of the future, the structural flexibility and innovative power were listed among the top drivers of future success.

Today, companies are facing a competitive and continuously changing situation. In this context the performance, and even the survival of companies depend more than ever on their ability to achieve a solid and competitive position and on their flexibility, adaptability and responsiveness. Therefore, it is hardly surprising that there is growing interest in innovation as a strategy that allows the enterprise to improve its flexibility, competitive position and performance.

A company will create new products for a variety of reasons, but usually in an

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attempt to increase profits. The most profitable new products will be those that meet the customer needs more effectively than competitors' products, and are therefore preferred by more customers. Companies need to identify those needs, and then generate ideas and solutions to address them.

Many articles on innovation and creativity begin with a general statement that companies must innovate or they will die. While this is generally true, any company that is inefficient in vetting and implementing new product ideas or a company that continually introduces the wrong products will consume its own resources and will also fail.

In the management field, a host of variables has been identified as influencing organisational innovation:

- having a vision of what the organisation wishes to be,
- searching for opportunities, experience and technological potential
- following market orientation,
- market evolution and segmentation and the promotion and management of creative resources.

Human factors and, in particular, human resource management, are today considered key elements of successful innovation, since the human element is involved in the whole innovation process. Specialists state that there are no good technologies or good innovations without competent people who can adequately use them and get benefit from them. At the same time, no competent people can be available if there is not, first, a business project defining the role that technology and innovation must play and creating the necessary and sufficient conditions for channelling aptitudes, capacities and attitudes of the individuals towards the established direction.

Considering that HRM determines and modifies, to a large extent, these aptitudes, capacities and attitudes, it seems clear that it becomes a crucial element in the development of innovation activities. Human resource management has been, up to now, scarcely treated in studies on innovation in the firm. Although there have been some empirical studies in recent years, their conclusions are heterogeneous and most of them have focused on U.S. firms.

## **2. SMEs in the European economy**

Given their importance in the European economy, the European Parliament acknowledges that SMEs are among the key elements in ensuring the success of the objectives of the single European market, relating to growth, employment, quality, diversification and flexibility in business. In so doing the Parliament implicitly recognizes that SMEs are better able to react to changes in policy, and in economic and social conditions.

Europe continues to offer potential to generate competitive advantage. Economic convergence means that firms must think of new ways of thinking about services and products, and take innovative approaches to markets. Such market-led change requires restructuring of business organization and operations.

There is a clear need for European organizations of all sizes to respond to this evolving environment. Leaders and managers need to think and act across European national and cultural borders. There are signs of an acceleration in Europeanization in a number of areas, for example in human capital and mobility, in innovative business practice and in new patterns of management.

The single European market requires a new outlook of business managers and owners. Markets are generally now multi-cultural and trans-national. Large companies have responded to this by adopting a similar cultural profile and by internationalizing their operations. The challenge to SMEs is not whether or not to follow, but how?

The Euromanagement paradigm can be seen as contingent on the development of the single European market. Indeed, Specialists argue that the development of management in western Europe is the key to economic revival and survival.

Organizations must also rethink commonly held competences to take in global and cross-cultural perspectives, in terms of language, of cultural values, of political and economic infrastructure, and, not least, business practices. None of this can be properly achieved without the full involvement of employees. To build an international workforce requires the development of a shared mind set, making use of best management and human resource practices, all driven by a leadership that has an appetite and capacity for change. In essence European managers are looking for a reflection of social values in their employment:

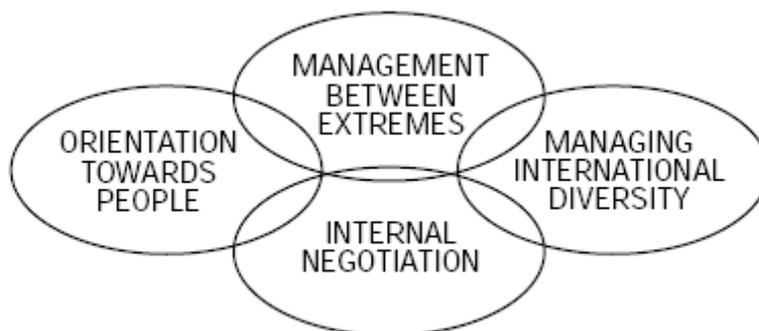
- *affective, pleasant aspects of job conditions and work environments;*
- *for personal development opportunities in a job;*
- *equitable rewards for work (for example pay, job security and promotion).*

The requirement for change needed to bring about effective managerial leadership, the need for a sense of European management identity, not running counter to national identity, but one building on the variety that so effectively characterises Europe. Such change they see as necessary because of the proliferation of “bad habits” in management:

- *the tendency towards risk aversion;*
- *continuing conflicts between professional groups;*
- *solving only safe issues;*
- *the failure of firms to avoid disputes.*

The advent of the single European market is the opportunity to develop Euromanagers, and so to clarify the ambiguity over the role of manager in Europe. In so doing they forecast the need for a realistic assessment of managerial practice, to gain a social understanding of management. The goals of a properly established school of management they see as:

- *the integration of different systems [of management];*
- *the acceptance of pluralism;*
- *the combination of scientific and rational thinking.*



**Figure 1 - Common characteristics of European management**

Building on these basis experts identify the so-called common characteristics of European management (see Figure 1):

- “*an orientation towards people* – a common inclination towards the fulfilment of individuals, caring for people and social responsibilities ... partly based on the notion that profit is not all ...”;

- “*internal negotiation* ... the top management has power, but it has to consult, to discuss, to negotiate, to convince ...”;

- “*skills in managing international diversity* – European business leaders are better equipped to deal with cultural diversity, geographical diversity than most American managers ... Europeans have more respect for foreign cultures and for foreign management styles ...”;

- “*managing between extremes* – Europe is in-between ... it is halfway between the US model of management and the Japanese model”; coupled with two lesser traits:

- “*product (engineer) orientation* – the domination by brilliant engineers (designing wonderful products) over marketers (leading to a lack of customer orientation and uneven skills in marketing)”;

- “a more intuitive and less formalised management – it seems that the Europeans ... rely more on agreement, dialogue and conviction, on experiences and the sense of responsibility of people”.

There are many and varied models of management of SMEs. The main difficulty in deciphering all of these is the blurring between the notion of SME management and entrepreneurship.

Experts in analysing many of the various models of competences and skills (and this is by no means an exhaustive sample) found a wide range of competences that are covered in training and development (see Table I).

**Table I – Competences in training**

	<i>Communication skills (listening, consulting, explaining, dialogue)</i>
<b>Ability to involve people</b>	<i>Skills in psychology (understanding people, cultural differences)</i>
	<i>Capacity to work in teams (multi-national, multi-level, multicultural)</i>
	<i>Capacity to co-ordinate, to create enthusiasm and to motivate</i>
	<i>International experience</i>
<b>International skills</b>	<i>Competence in several languages (three minimum)</i>
	<i>Geographical mobility</i>
	<i>Global thinking</i>
	<i>Aptitude to manage change</i>
<b>Flexibility</b>	<i>Aptitude to manage diversity</i>
	<i>Tolerance to ambiguity and uncertainty</i>
	<i>Capacity to learn (self-evaluation and openness)</i>
<b>Intuition</b>	<i>Intuition</i>
	<i>Creativity, ability to innovate</i>
	<i>Aptitude to have a general view of a situation (combining</i>
<b>Broad vision</b>	<i>several disciplines, considering the historical context, and taking a systematic approach)</i>
	<i>Deep understanding (sociological, philosophical, ethical)</i>

**Source: Dufour (1994)**

### **3. The relationship between innovation and HRM**

There are no best HR practices, because in order to be effective, HR practices must be consistent with other aspects of the organisation, specifically its strategy. The most suitable HRM practices for firms trying to develop a competitive advantage based on innovation will be different to those practices suitable for firms seeking other kind of competitive advantage.

Some studies have focused on some isolated HRM practices while others have focused on the HR system adopted by the firms. The underlying assumption of these studies is that the impact on organisational performance of sets or “bundles” of interrelated HR practices can be greater than the cumulative impact of all the individual practices comprising the bundle. Most of the above mentioned studies are based on the models proposed by well-known specialists (Miles and Snow and Schuler and Jackson). Their model proposes the development of a market-type HRM system for those firms defined as prospectors, firms characterised by the search for new products and markets, which are, therefore, the innovators. They argue that it is very difficult for the firm to provide the necessary abilities for a new market or product from inside the company and, more importantly, to provide them quickly.

Therefore, these authors recommend searching outside for these abilities whenever the organisation needs them, i.e. developing a market-type HRM system.

Other specialists (Schuler and Jackson) establish a connection between HRM practices and three types of strategy: costs, quality and innovation, defined from Porter's (1980) classification of competitive strategies. Their model starts by analysing the employees' behaviour required by each kind of strategy; subsequently they propose HRM practices for the development of these behaviours. In their view, when contemplating an innovation strategy, the enterprise needs creative employees who are flexible and tolerant of uncertainty and ambiguity; people who are able to take risks and assume responsibilities, very skilful, able to work in a cooperative and interdependent way and with a long-term orientation.

The HRM practices that those systems include are listed in Table I.

We can say that, between specialists, there is agreement, firstly on the importance of linking HRM and innovation and, second, regarding the form of some HRM practices, particularly the use of external sources of recruitment, performance appraisals and incentives. There is no consensus regarding other HRM practices such as employment security, training, career paths or employee participation. Furthermore, empirical research conclusions are also heterogeneous.

For this reason, can be formulated propositions about the relationship between innovation and HRM practices following both Miles and Snow (1984) and Schuler and Jackson (1987).

The first hypothesis refers to isolated HRM practices.

**1. The strategy developed by a company determines the HRM practices it carries out.** Thus, innovative companies will carry out HRM practices consistent with this strategy.

This hypothesis is broken down into two according to the theoretical model employed:

*a. Companies following an innovation strategy will be characterised by the use of external sources of recruitment, low employment security, narrow application of training, very little use of internal career paths, the use of performance appraisal systems, incentive-based compensation and low employee participation.*

*b. Companies following an innovation strategy will be characterised by the use of external sources of recruitment, high employment security, broad application of training, the use of internal career paths, the use of performance appraisal systems, incentive-based compensation and high employee participation.*

The second hypothesis is formulated from a configurational perspective:

**2. The strategy developed by a company determines the HRM system it implements.** Thus, innovative enterprises will implement an HRM system consistent with this strategy.

As in the previous case, alternative hypotheses are formulated according to the reference models, Miles and Snow (1984) or Schuler and Jackson (1987):

*a. Companies following an innovation strategy will adopt an HRM system characterized by*

*the use of external sources of recruitment, low employment security, narrow application of training, very little use of internal career paths, the use of performance appraisal systems, incentive-based compensation and low employee participation.*

*b. Companies following an innovation strategy will adopt an HRM system characterized by the use of external sources of recruitment, high employment security, broad application of training, the use of internal career paths, the use of performance appraisal systems, incentive-based compensation and high employee participation.*

The assumption that strategy determines the firm's HRM practices is implicit in these hypotheses, as most of the contingent literature suggests.

**3. The HRM practices developed by a firm determine its strategy.** Thus, firms that carry out HRM practices consistent with innovation will follow an innovation strategy.

*a. Companies characterised by the use of external sources of recruitment, low employment security, narrow application of training, very little use of internal career paths, the use of performance appraisal systems, incentive-based compensation and low employee participation will seek a more innovative strategy.*

*b. Companies characterised by the use of external sources of recruitment, high employment security, broad application of training, the use of internal career paths, the use of performance appraisal systems, incentive-based compensation and high employee participation will seek a more innovative strategy.*

Regarding the configurational approach, the following hypotheses are formulated:

**4. The HRM system developed by a company determines its strategy.** Thus, companies that implement an HRM system consistent with innovation will follow an innovation strategy.

*a. Companies adopting an HRM system characterised by the use of external sources of recruitment, low employment security, narrow application of training, very little use of internal career paths, the use of performance appraisal systems, incentive-based compensation and low employee participation will seek a more innovative strategy.*

*b. Companies adopting an HRM system characterised by the use of external sources of recruitment, high employment security, broad application of training, the use of internal career paths, the use of performance appraisal systems, incentive-based compensation and high employee participation will seek a more innovative strategy.*

Table 1 - HRM practices for innovation

	Miles and Snow's model	Schuler and Jackson's model
<i>Recruitment and selection</i>	Emphasis: "buy" Hiring almost exclusively from outside the organisation Selection may involve pre-employment psychological testing Very little employment security given Little if any socialisation taking place within the organisation	External sources of recruitment Technical and research competencies High employment security
<i>Training</i>	Skill identification and acquisition Limited training programmes	Broad application Employees are responsible for learning Jobs that allow employees to develop skills that can be used in other positions in the firm
<i>Development and internal career opportunities</i> <i>Performance appraisal</i>	Very little use of internal career ladders Results-oriented procedure Identification of staffing needs Division/corporate performance evaluations Cross-sectional comparisons	Broad career paths Mandatory competency growth Process and results criteria Performance appraisals that are more likely to reflect longer-term and group-based achievements
<i>Compensation</i>	Oriented toward performance External competitiveness Total compensation heavily oriented towards incentives and driven by recruitment needs	Many incentives Internal equity Low pay rates but employees are allowed to be stockholders and have more freedom to choose the mix of components that make up their package Team innovation awards Competency-based pay
<i>Other HRM practices</i>	Low employee participation Implicit job analysis Job enrichment	High employee participation Implicit job analysis Job enrichment Cross-functional teams Communication: feedback on new product sales

*source:* Daniel Jimenez-Jimenez and Raquel Sanz-Valle

Some European studies based on the models mentioned above, on small and medium enterprises, revealed the relation between HRM and innovation. According to the literature, HRM is a key element for the success of innovation, not many empirical studies have provided support for it.

Using a contingency approach, different strategies will require different employee skills, knowledge and behaviours to be implemented. Presumably, HRM policies can influence these employee characteristics.

There is agreement between specialists about, first of all, the relationship between innovation and HRM and, second, that in order to improve innovation, the

adoption of HRM bundles is superior to any of the individual HRM practices of which they are composed. On the other hand, there are inconsistencies in the literature about the contents of these bundles. Some authors suggest that employment security, extensive training or employee participation have a positive impact on innovation, while others think they have the reverse effect.

#### 4. Conclusions

Alternative hypotheses, following the two most widely-accepted theoretical models, have been proposed in this paper. The conclusions drawn from European studies about HRM impact on companies' innovations using the above models are the following:

- There are empirical evidences that innovation explains the adoption of some HRM practices. The choice of an innovation strategy implies the use of an incentive-based compensation, the encouragement of employee participation, the use of appraisal systems and the use of broad internal career opportunities.
- The HRM practices condition the firm's orientation towards innovation. The participation and the use of promotion plans significantly explain the firm's innovation orientation.

The importance of aligning HRM practices and innovation is a clear implication for managers. Schuler and Jackson's model and Miles and Snow's explains the fit between innovation and HRM. The firms that adopt an innovation strategy are more likely to use internal labour markets than external ones.

The use of HRM practices aimed at building a stable group of employees in the company, which can adopt risks and experiment and which can participate in the adoption of the decisions that affect their jobs. This is more likely to create the conditions for the emergence of the new ideas that feed innovation.

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**ACCOUNTING OF LEASE CONTRACTS ACCORDING TO IAS 17  
"LEASING CONTRACTS"***Boni Străoanu, Daniela Iov\****Abstract**

*Leasing is a medium term (movable leasing) or long term (real estate leasing) financing technique, as an alternative to indebtedness, allowing a firm to exploit goods without being forced to rely on loans or own capitals. The specialized financial institution, as owner of the goods (lessor), will assign the goods to a user (lessee) based on a firm request and against payment of a rent, which can include, as the case may be: amortization of the asset; remuneration of the invested capital (based on commission); risk premium due to the fact that the financial institution (lessor) bears the entire financing; administrative expenses. This article presents the registration of the leasing in accounting, according to IAS 17, both from the point of view of the lessor, and from that of the lessee.*

**Keywords:** lessor, lessee, financial leasing, interest rate, residual value, amortization

**JEL Classification:** K34, M41

**Introduction**

Leasing operations constituted one of the controversy subjects in the accounting theory, finally leading to the imposition of the principle of prevalence of *substance over form*.

The controversy was disputed between the legal (patrimonial) approach and the economic one of the accounting balance. According to the legal theory, the balance shows the legal status of the company at a given time – i.e. the goods in the possession of the company, debt rights, as well as their relevant obligations. However, along with the evolution of the economic activity, in the business practice there appeared certain transactions (leasing operations, sales with property reserve clause, sales with redemption clause, debt factoring), which, although are circumscribed (sometimes) into a traditional legal figure, they have a totally different economic content than their legal form shows. And if such operations would be accounted according to their legal form and not their economic substance, the information supplied by the financial situations would no longer be relevant, and

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accounting would not achieve its fundamental target of presenting a true image of the *economic reality*.

Where the *lease contracts* are concerned, these are agreements by which the *lessor* – legal owner of the goods, assigns to the *lessee*, for a determined period of time, the right to use an asset, against one payment or a series of payments.

In certain circumstances, leasing operations place the lessee in the same economic position it would have had if it had chosen an external loan aimed at buying the goods forming the subject of the lease contract. We say only *economic*, not also *legal*, since from the legal point of view there is no similitude, the right of ownership over the goods not being transferred to the user but remaining with the lessor. This differentiation between the *legal* nature and the *economic* nature of leasing lead to numerous discussions, not being known whether, on drawing up the financial situations, there should be taken into consideration the obvious financial substance of certain operations or their legal nature. Otherwise told, if the leased goods should be recorded in lessee's balance although it does not hold the right of ownership over such goods.

## Accounting Instrumentation of Lease Contracts

### 1. Financial leasing in lessee's financial statements

On the **contract commencement date**, the lessee will account an **asset** and a **liability** assessed at the **true value** of the goods; or, if lower, the **updated value of the minimum leasing payments** determined on the initiation date of the contract.

The costs incurred by the lessee, which can be attributed directly to the contract (such as costs related to negotiations) are not recorded in the profit and loss account, but capitalized by the increase of the value of the leased goods.

Amortization of the goods will be recorded by the lessee, as it is the one consuming the majority of the economic benefits produced by the asset which forms the subject of the contract. Under conditions in which there is the reasonable certainty that the right of ownership will be transferred to the lessee at the end of the contract, then there can be established a useful life duration exceeding the duration of the contract.

**Example:** Commercial Company X and Commercial Company Y enter into a lease contract on January 1, 2005, the subject being an industrial piece of equipment.

The main contract data are:

- *Acquisition cost from the supplier:* RON 11,000,000.
- *Leasing period:* 5 years.
- *Initial payment*
- *Leasing installments:* 5 annual installments amounting to RON 3,000,000 each, paid on December 31 of each year.
- *Option price:* the option to buy may be exercised at the end of the contract, at

the value of RON 500,000.

- *Economic life duration of the piece of equipment:* 6 months.
- *Residual value:* RON 1,500,000.
- *Residual value warranted by the lessee:* 20%.

To enter into the contract, the lessee made expenses with economic-legal counseling in view of the negotiation amounting to RON 10,000, which were invoiced on December 22, 2004.

### **Solution:**

#### **Stage 1. Contract rating:**

The above contract is a financial leasing contract because it observes at least two of the criteria requested by IAS 17:

1) The contract duration (5 years) covers most of the economic life duration of the piece of equipment (6 years), i.e. approximately 83%.

2) The option price (RON 500,000) is sufficiently advantageous in comparison with the residual value (RON 1,500,000) – approximately 33% of the residual value – so that there is the reasonable certainty that the piece of equipment will be bought by the lessee at the end of the contract.

#### **Stage 2. Calculation of the implicit interest rate:**

$$11.000.000 = 2.000.000 + \sum_{t=1}^5 \frac{3.000.000}{(1+i)^t} + \frac{500.000}{(1+i)^5} + \frac{1.000.000}{(1+i)^5}$$

where,

$i$  = rate of actual/implicit interest of the contract;

$t$  = number of years.

From the calculation results  $i = 22.71615\%$ .

#### **Stage 3. Calculation of the updated values of minimum leasing payments (VP(PML))**

$$VP(PML) = 2.000.000 + \sum_{t=1}^5 \frac{3.000.000}{(1+i)^t} + \frac{500.000}{(1+i)^5} = 10.640.672 \text{ RON}$$

The updated value of the minimum leasing payments (RON 10,640,672) is lower than the fair value of the piece of equipment (RON 11,000,000).

**Stage 4.** Elaboration of the reimbursement table

Date	Principal to be reimbursed at the beginning of the financial service	Payments	Interest	Reimbursed principal	Principal left to be reimbursed at the end of the financial service
(1)	(2)	(3)	(4) = (2) x 22.71615%	(5) = (3) – (4)	(6) = (2) – (5)
01.01.2005	10,640,672	2,000,000	0	2,000,000	8,640,672
31.12.2005	8,640,672	3,000,000	1,962,828	1,037,172	7,603,500
31.12.2006	7,603,500	3,000,000	1,727,222	1,272,778	6,330,722
31.12.2007	6,330,722	3,000,000	1,438,096	1,561,904	4,768,819
31.12.2008	4,678,819	3,000,000	1,083,292	1,916,708	2,852,111
31.12.2009	2,852,111	3,000,500	647,889	2,852,111	0

**Stage 5.** Recording of the lease contract

On **22.12.2004** the expenses related to contract negotiation are recorded

231 “Immobilization under way” = 401 “Suppliers” 10.000

On **01.01.2005** (date of commencement of the leasing period) there will be recorded:

- reception of the goods, at the level of updated minimum leasing payments:  
*“Industrial equipment” = “Other long-term loans” 10,640,672*  
*Lease contracts”*
- capitalization of expenses related to negotiations:  
*“Industrial equipment” = “Immobilizations under way” 10,000*
- accounting of the initial payment;  
*“Other long-term loans” = “Checking accounts with banks” 2,000,000*  
*Lease contracts”*

On **31.12.2005** there will be recorded:

- payment of the first leasing installment:  
% = *“Checking accounts with banks” 3,000,000*  
*“Other long-term loans.*  
*Lease contracts” 1,037,172*  
*“Expenses related to interest” 1,962,828*

- recording of the amortization of the goods:

Amortization of the goods in linear regime:

- useful life duration: 6 years;

- residual value (assessed at the end of the useful life duration): RON 0.

Amortizable value:  $10,640,672 + 10,000 - 0 = \text{lei } 10,650,672$

Annual amortization:  $10,650,672 / 6 = \text{RON } 1,775,112/\text{year}$

"Amortization expenses" = "Corporal immobilizations amortization" 1,775,112  
Corporal immobilization"

The records at the end of 2005 are repeated each year until the end of the contract.

## 2. Financial leasing in lessee's financial statements

At the commencement of the contract, the lessee will record a **debt** (granted loan) assessed at an equal value with a **net investment in the lease**, representing the **gross investment in the lease** updated to the implicit interest rate. The **gross investment** represents the amount between the minimum leasing payments and any unguaranteed residual value. The difference between the gross investment and its updated value represents the **unearned finance income**.

Practically the debt will be recorded at the fair value of the goods (represented, usually, by the cost of acquisition of the goods from the supplier) plus other costs which are directly related with the conclusion of the contract (such as: negotiation costs). Consequently the expenses which can be directly related to the contract are not recorded in the profit and loss account but are capitalized by increasing the value of the debt.

The lessor no longer presents the goods in financial leasing in its balance since it no longer has control over such goods (no longer holds the majority of advantages and risks related to the property) and no longer records the amortization thereof.

The unearned finance income will be allotted/recognized along the leasing period so as to reflect a constant interest rate over the net investment.

**Example:** We will solve below the previous example from lessor's point of view.

### Solution:

#### Stage 1. Contract rating:

The contract the data of which were stated is a financial leased contract from the same considerations presented above.

**Stage 2.** Calculation of the implicit interest rate:

The implicit interest rate of the contract (calculated above):  $i = 22.71615\%$ .

**Stage 3.** Calculation of the net investment in the lease (INL):

INL = Updated gross investment in the lease (VP(IBL))

$$VP(IBL) = 2.000.000 + \sum_{t=1}^5 \frac{3.000.000}{(1+i)^t} + \frac{500.000}{(1+i)^5} + 1.000.000 = 11.000.000 \text{ RON}$$

**Stage 4.** Calculation of the unearned financed income and constant remuneration rate of the net investment ( $r$ )

$$VFN = IBL - VP(IBL) = IBL - INL$$

$$IBL = 2,000,000 + 5 \times 3,000,000 + 500,000 + 1,000,000 = \text{RON } 18,500,000$$

$$VFN = 18,500,000 - 11,000,000 = \text{RON } 7,500,000$$

The unearned finance income represents the remuneration of the net investment, the investment unrecovered by the minimum leasing payments. Consequently, in order to allot the financial income related to the contract along the leasing period, there will be calculated the interest rate required to update the minimum leasing payments so that it reimburses the presented value of the net investment.

$$11.000.000 = 2.000.000 + \sum_{t=1}^5 \frac{3.000.000}{(1+r)^t} + \frac{500.000}{(1+r)^5}$$

From calculations there results  $r = 20.852815\%$

**Stage 5.** Elaboration of the reimbursement and allotment of the financial income table

Date	Principal to be reimbursed at the beginning of the financial service	Payments	Interest	Reimbursed principal	Principal left to be reimbursed at the end of the financial service
(1)	(2)	(3)	(4) = (2) x 22.71615%	(5) = (3) - (4)	(6) = (2) - (5)
01.01.2005	11,000,000	2,000,000	0	2,000,000	9,000,000
31.12.2005	9,000,000	3,000,000	1,876,753	1,123,247	7,876,753

31.12.2006	7,876,753	3,000,000	1,642,525	1,357,475	6,519,278
31.12.2007	6,519,278	3,000,000	1,359,453	1,640,547	4,878,731
31.12.2008	4,878,731	3,000,000	1,017,353	1,982,647	2,896,085
31.12.2009	2,896,085	3,000,500	603,915	2,896,085	0

### Stage 6. Recording of the lease contract

On **01.01.2005** there will be recorded:

- assignment of the goods at the level of the net investment in the lease equal to the fair value of the goods on the contract commencement date:

*"Other long-term debts" = "Industrial equipment" 11,000,000*  
*Lease contracts"*

- collection of the initial payment

*"Checking accounts with banks" = "Long-term debts. 2,000,000*  
*Lease contracts"*

On **31.12.2005** there will be recorded the collection of the first leasing installment:

*"Checking accounts with banks" = % 1,000,000*

*"Other long-term debts.*

*Lease contracts" 110,884*

*"Income from interest" 889,176*

Amortization of the goods: not recorded, the goods being taken out of lessor's assets.

The records at the end of 2005 are repeated each year until the end of the leasing period with the amounts in the reimbursement table.

### 3. Operational leasing in lessee's financial statements

The goods taken in leasing are not recognized in the balance since the lessee does not hold control over them. The leasing payments are recognized as an **expense** in the profit and loss account over the duration of the contract.

**Example.** Commercial Company X SRL and Commercial Company Y SRL enter into a lease contract on January 1, 2005, having as subject one Minolta type EC400 copier.

The main contract data are:

- *Acquisition cost from the supplier:* RON 11,000,000
- *Leasing period:* 4 years.
- *Leasing installments:* 4 annual installments amounting to RON 1,000,000 each, payable on December 31 of each year.
- *Option price:* the option to buy may be exercised at the end of the contract, at

the value of RON 10,500,000.

- *Residual value of the piece of equipment at the end of the contract:* RON 10,700,000.
- Economic life duration of the piece of equipment: 10 years.

### Solution:

#### Stage 1. Contract rating:

The above contract is an operational lease contract since it does not observe any of the criteria requested by IAS 17:

- the contract does not provide transfer of the ownership right at the end of the leasing period;
- the option to buy the piece of equipment cannot be exercised at a sufficiently advantageous price (10,500,000 as compared to 10,700,000) in order to exist a reasonable certainty that the piece of equipment will be bought at the end of the contract;
- the contract does not cover most of the economic life duration of the piece of equipment (4 years as compared to 10 years);
- the updated value of the minimum payments on contract commencement date is not equal or greater than the fair value of the piece of equipment on that date:

$$11.000.000 \gg \sum_{t=1}^4 \frac{1.000.000}{(1+i)^t}$$

- the asset forming the subject of the contract does not have a specific nature, so only the lessee can use it without significant alterations.

#### Stage 2. Elaboration of the reimbursement table

Date	Payments
(1)	(2)
2005	1,000,000
2006	1,000,000
2007	1,000,000
2008	1,000,000

#### Stage 3. Accounting of the lease contract

On **01.01.2005** there will not be recorded the receipt of the piece of equipment in the lessee's balance as it does not have control over the resource (does not have majority of advantages and risks related to the piece of equipment):

On **31.12.2005** there will be recorded payment of the first leasing installment:

$$\text{“Royalty expenses”} = \text{“Checking accounts” } 1,000,000$$

Amortization of the piece of equipment: not recorded by the lessee, not recognizing the piece of equipment in the balance.

#### 4. Operational leasing in lessor's financial statements

The piece of equipment forming the subject of the lease contract is shown in the balance according to its nature. The leasing payments are recognized as **income** into the profit and loss account for the duration of the contract.

**Example.** We take into consideration the same issue presented above from the point of view of the lessor.

#### Solution:

##### Stage 1. Contract rating:

The above contract is an operational lease contract as it does not observe any of the criteria requested by IAS 17, as shown in the above example.

##### Stage 2. Elaboration of the reimbursement table

Date	Collections
(1)	(2)
2005	1,000,000
2006	1,000,000
2007	1,000,000
2008	1,000,000

##### Stage 3. Accounting of the lease contract

On **01.01.2005** the assignment of the piece of equipment there will not be recorded as the lessor continues to have control over the resource, continuing to show it in its balance.

On **31.12.2005** there will be recorded:

- collection of the first leasing installment:

*"Checking accounts with banks"* = *"Income from royalties"* 1,000,000

Amortization of the piece of equipment is recorded by the lessor, it continuing to recognize the piece of equipment in the balance.

Amortization of the piece of equipment in linear regime:

- useful life duration: 10 years;
- residual value: RON 1,000,000.

Amortizable value:  $11,000,000 - 1,000,000 = \text{lei } 10,000,000$

Annual amortization:  $10,000,000 / 10 = \text{RON } 1,000,000/\text{year}$

*“Amortization expenses = “Corporal immobilizations amortization” 1,000,000 corporal immobilizations”*

## Conclusions

The impact if the leasing operation on the accounting statements of the lessee company differs according to the type of leasing contracted.

Thus, in the case of operational leasing, modifications are not produced at balance level, the operation being recorded outside the balance, as a consequence the degree of indebtedness of the company remains unchanged, not altering company's capacity to contract debts, this representing an advantage in case of attracting new investors, since this type of leasing determines a fictitious increase of company's profitability. The lease paid by the lessee is recorded as an exploitation expense in its profit and loss account. Considering its outside of balance recording, the financial analysts may overlook such capitals invested in the company, similar to debts, the increase of the economic profitability resulting from the reporting of the exploitation profit.

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## THE COMPARATIVE ANALYSIS OF ROMANIA'S BUDGET DEFICIT COMPARED TO THE EUROPEAN UNION MEMBER STATES

Rodica Gherghina, Ioana Duca, Mirela Anca Postole\*

### Abstract

*In their research, the authors started from the premise that, in an emerging economy, it is important that the fiscal, budget and monetary policy measures should keep the long-term indebtedness level constant, so that the amount of public debt should increase at the same rate as the nominal GDP. In this context, the monetary policy must have as main objective to control inflation, because the inflation rate directly influences the long-term nominal GDP growth rate. Yet, this monetary policy direction must be supervised permanently, because a high long-term inflation rate leads to an increase in the nominal GDP, contributing to the increase in the nominal interest rate. Besides, the monetary policy combined with the fiscal-budgetary policy must aim at covering the budget deficits and at decreasing the public debt. In our opinion, chronic budget deficits and a high public debt level have a negative impact on economic growth. Consequently, the two budget indicators must be analysed in correlation with the GDP. We consider that both Romania as a European Union member state, and the other member states must permanently revise, through specific procedures, the budget deficit level in relation to the GDP and the indebtedness level.\**

**Keywords:** budget deficit, public debt, inflation rate, nominal GDP

**JEL Classification:** H6, H62, H63, H68

### Introduction

The problems related to budgetary equilibrium are closely related to the budgetary policy and to the fiscal policy. The fiscal-budgetary policy role consists in accepting the budgetary disequilibrium or not. The monetary policy combined with the fiscal-budgetary policy must aim at covering the budget deficits and at decreasing the public debt.

At the monetary policy level, the main influence has been represented by the level of financing the budget deficit and refinancing the public debt; the budget deficit is financed from domestic and external sources. The strategy to finance the budget deficit and to refinance the public debt will be based on taking out loans on the domestic market and on issuing state bonds. In Romania, loans taken out in order to finance and refinance budget deficits have been used to a very large extent to

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cover certain consumption expenditures and to a very little extent for economic and social development needs. This proves that, during the transition period, the Romanian society broke one of the axioms of any society which aims at progress, by consuming more than it produced.

### **Theoretical perspectives on the budget deficit. The evolution of the budget deficit in Romania**

The state's economic role has been estimated in various economic theories, classical, liberal, neoclassical ones, the economic doctrine regarding the state's intervention in the economy undergoing permanent changes.

After the Great Depression (1929-1933), but especially after World War II, a new concept was created, namely the welfare state: [Dobrotă, (1999)] „the state whose main function is to correct the negative effects of the market”. The doctrine regarding the welfare state was a combination of the market economy and the socialist economy and it was most widely spread in the United States of America and Europe. After World War II until the early 1970s, market economies, driven by the expansionist fiscal and monetary policies, recorded a considerable economic growth. After the 1970s, both in Western European countries and in the United States of America increases in public expenditures were recorded, especially at social level.

In our opinion, the indifference to the constant growth in public expenditure led to the emergence of budgetary disequilibriums and consequently to a change in public debt. Among the first causes for the emergence of budget deficits there are: the continuously increasing expenditures on maintaining governmental bodies; the continuous increase in the expenditures on reimbursing the public debt (a part of it usually being generated precisely by financing the previous years' budget deficits); the huge increase in inflation; large, unproductive expenditures, etc.

Consequently, the monetary policy combined with the fiscal-budgetary policy must aim at covering the budget deficits and at decreasing the public debt. Besides, the developed countries' experience proves the need to use a mixed, balanced policy: [Manolescu, (1997)]. For example, the United States of America, in the interval 1979-1985, adopted an imbalanced combination between the fiscal-budgetary policy and the monetary one (firstly, a restrictive monetary policy, then an expansionist fiscal-budgetary policy – decreases in taxes that caused a high budget deficit which led to loans).

In the specialised literature, several authors [Dornbusch and Fischer, (1990)], emphasised the possibility that the ones in charge of public policies resort to financing the budget deficit by several means, namely:

- by reducing the budget expenditures;
- by increasing fiscal revenues;
- by issuing money;
- by resorting to domestic and external loans, generating public debt.

Yet, each means of financing the deficit is controversial. There is no better or worse method, for each of them there are for and against arguments according to the economic, political and social context in which it is applied.

One of the simple “definitions” of the budget deficit shows that it appears as a negative balance of the analysed budget, between the revenues and the expenditures incurred at the level of a financial exercise. According to certain authors, [Easterly, (1989)] the budget deficit may be covered by resorting to loans from international financial institutions, commercial banks, economic agents or even the population. It is well known that chronic budget deficits and a high public debt level have a negative impact on economic growth, [Traçlet, (2004)]. For this reason, the increase in budget deficits and public debt in industrialised countries in the 1980s and 1990s occurred simultaneously with the increase in the real interest rates, which attracted the increase in the costs regarding the public debt service and the decrease in productive investments, [Traçlet (2004)].

Numerous authors: [Nunes-Correia and Stemitsiotis, (1993)]; [Fillion, (1996)]; [Laubach, (2003)] in their studies based on empirical analyses, demonstrated the effects of the interest rate on the size of the budget deficit and the public debt. Another author, [Dahan, (1998)], studies the impact of the monetary policy on the budget deficit. His research emphasises various influence channels through which the monetary policy can change the size of the budget deficit.

These influence channels are based on a series of factors which depend on the level of prices, public expenditures, fiscal revenues, public debt, issuing money, interest rate etc. But, in each and every state, according to the economic situation, the public decision-makers are the one taking decisions related to what must be done about the budget deficit policy. In the specialised literature as well as in the practice of international financial institutions such as the World Bank and the International Monetary Fund several indicators are used to measure the budget deficit or the budget balance, [Jacobs, (2002)]. The most widely used indicator is the conventional budget balance, which represents all the resources used by the government during one fiscal year, resources used in financing the part of the expenditures not covered by the revenues: [Blejer and Cheasty, (1993)]; [Jacobs, (2002)].

The World Bank defines the conventional balance as the difference between expenditures (e.g., salary expenditures, expenditures on goods and services, capital expenditures, expenditures on the public debt interests, transfer and subsidies) and the following revenues (taxes, grants from financial institutions, revenues from the sale of certain assets, the state capital enterprises’ own revenues).

The authors, [Diamond and Schiller,(1993)] specified that the budget balance is equal to the following fiscal balance:

$$\text{Fiscal balance} = [(\text{revenues} + \text{grants}) - (\text{expenditures on goods and services} + \text{transfers}) - (\text{loans} - \text{refinancing})]$$

Therefore, the conventional budget balance or conventional deficit is the

difference between the overall revenues and the overall expenditures, difference which will have to be financed by resorting to public loans. Yet, we must specify that these overall expenditures must include the expenditures on the interests related to the public debt but not the instalments to be reimbursed for the public debt. Besides, the public financial disequilibrium is measured on the basis of several types of budget balances or budget deficits, the conventional balance being the starting point in calculating them.

In Romania, the Ministry of Public Finance and the National Bank of Romania annually calculate and report the following budget deficits:

- the consolidated general budget deficit/surplus or the conventional deficit/surplus;
- the primary deficit/surplus;
- the structural deficit/surplus;
- the current account deficit/surplus;
- the operational deficit/surplus.

The consolidated general budget deficit (the conventional deficit) largely expresses the financial disequilibrium between the public sector resources and needs. It is calculated as a difference between the consolidated general budget revenues and the expenditures associated with this budget.

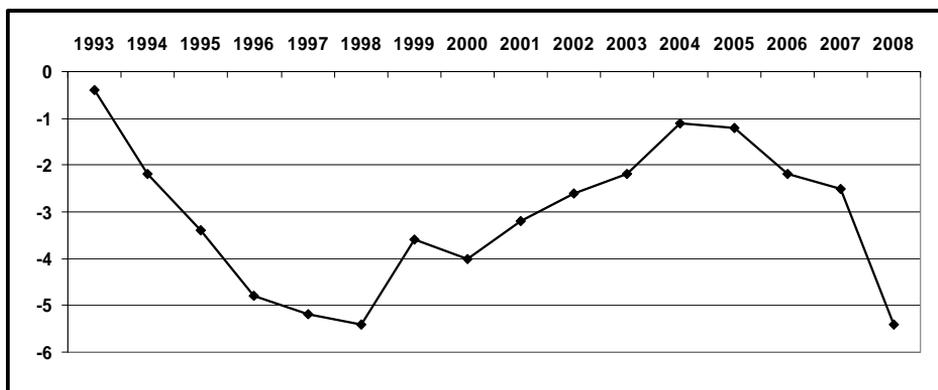
In table 1 and figure 1 the evolution and level of the general consolidated budget deficit in the interval 1993-2008 are presented.

**Table no.1 The consolidated general budget deficit level (% GDP), in the interval 1993-2008**

Reference years	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Consolidated general budget deficit (% GDP)	-0.4	-2.2	-3.4	-4.8	-5.2	-5.4	-3.6	-4.0	-3.2	-2.6	-2.2	-1.1	-1.2	-2.2	-2.5	-5.4

Source: IMF (May, 2006) Country Report No. 6/169; Eurostat (2008) EU Economic Data pocketbook, Quarterly 1, p.76-77.

**Figure no.1 The consolidated general budget deficit evolution (% GDP), in the interval 1993-2008**



Source: IMF (May, 2006) Country Report No. 6/169; Eurostat (2008) EU Economic Data pocketbook, Quarterly 1, p.76-77.

From the analysis of the consolidated general budget deficit level we notice that the main purpose of the economic policies mix was to keep it under control. Thus, until 2000, Romania underwent a vast reformation process, from a centralised economy to a market economy, yet, the budget deficit level was not very high compared to other European countries. After 2000, the deficit gradually decreased, in the context of a NBR monetary policy whose main objective was to lower the inflation year by year, also influencing the decrease in the deficit. Besides, the budget deficit criterion to maintain it below the level of 3% of the GDP has been observed in our country since 2002. The exception in our analysis is the year 2008, when the deficit reached 5.4% of the GDP, increasing mainly in the 3<sup>d</sup> and especially 4<sup>th</sup> quarter due to the expansionist fiscal-budgetary policies.

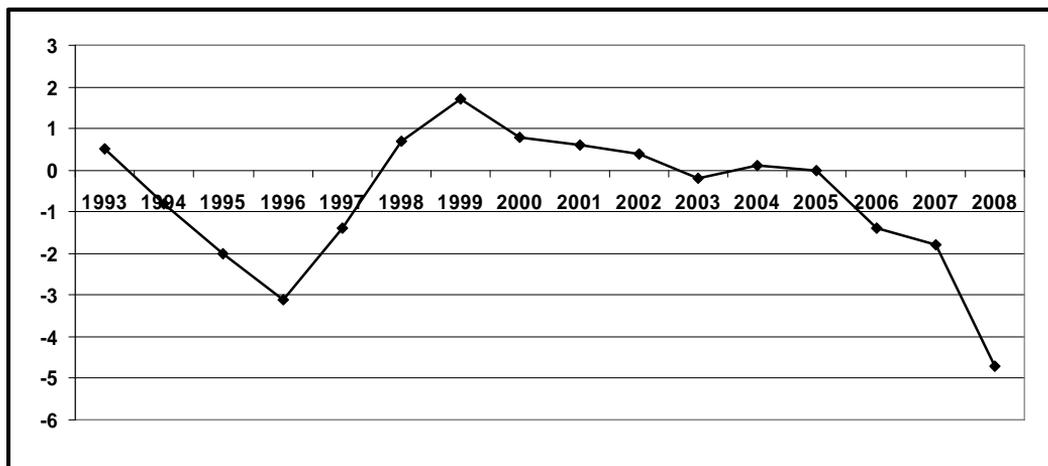
The primary deficit/surplus is the difference between the consolidated general budget deficit and the expenditures on the interests related to the public debt. It is an indicator used in analysing the fiscal and budgetary policies sustainability. The primary deficit/surplus level and evolution are presented in table 2 and figure 2.

**Table no. 2 The primary budget deficit level (% GDP), in the interval 1993-2008**

Reference years	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Primary deficit/surplus (% GDP)	0.5	-0.8	-2.0	-3.1	-1.4	0.7	1.7	0.8	0.6	0.4	-0.2	0.1	0	-1.4	-1.8	-4.7

Source: Calculated on the basis of the data from the International Monetary Fund (1993-2004) and Eurostat (2005-2008)

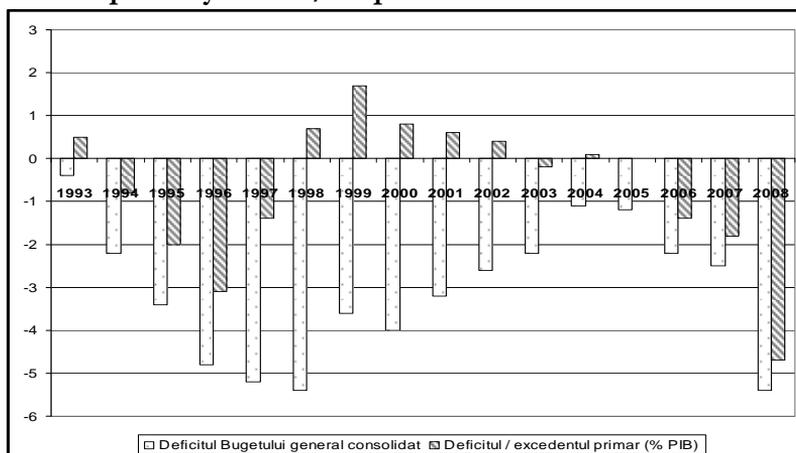
**Figure 2: The primary deficit/surplus evolution (% GDP), in the interval 1993-2008**



Source: Elaborated on the basis of the data from the International Monetary Fund (1993-2004) and Eurostat (2005-2008)

We notice that the primary balance recorded a surplus in 1993, and also in the interval 1998-2002, respectively in 2004, due to the high ratios of expenditures on the interests associated with the public debt to the GDP. By comparing the evolution of the two budget deficits – the conventional and the primary one (figure 3) we notice that in the interval in which the primary balance recorded a high deficit and the conventional balance also recorded a deficit. Besides, when the primary balance recorded a surplus, we notice that the conventional deficit increased.

**Figure 3: The evolution of Romania's consolidated general budget deficit and primary deficit/surplus in the interval 1993-2008**



Source: Elaborated on the basis of the data from the IMF and Eurostat (1993-2008)

The structural deficit/surplus – excludes from the conventional deficits the receipts from privatisation, which are considered sources of financing not of revenue. The structural deficit size and structure are established by the National Bank of Romania, which makes them public. There is an indicator used in the fiscal adjustment processes and in numerous studies regarding the fiscal and budgetary policies sustainability.

The current account deficit/surplus: [Jacobs, (2002)] is calculated as the difference between current budget revenues and current budget expenditures. It measures the government's savings level. The operational deficit/surplus: [Jacobs, (2002)] is calculated as a difference between the conventional balance and the inflationist component of the expenditures on interests (or it can also be defined as the primary deficit plus the real interest paid for the domestic public debt). It is an indicator which reflects the impact of the fiscal policy in the intervals with high inflation.

In order to finance these deficits, according to the data [IMF, (2006)] domestic resources were used frequently during this interval and external ones were used less. For this reason, the decision-makers, in order to finance the constantly growing budget deficits, must choose between increasing fiscal revenues (by increasing existing taxes or introducing new taxes) and taking out loans. In most cases the second solution is selected, for the following reasons:

- increasing taxes is an unpopular measure, because it immediately affects the population's standard of living, with immediate political consequences;
- state loans provide a faster means to find financial resources than indirect taxes;
- if the loan is taken out from the Central Bank, the interval for obtaining the money resources is the shortest, compared to issuing bonds to natural and legal persons.

Yet, today's reality clearly proves that loans are a more costly means of finding the financial resources necessary to the state than taxes; the interests and the other advantages granted to the state's creditors inevitably increase public expenditures.

### **Romania's budget deficit versus the budget deficit of the European Union member states**

In their research, the authors made a comparative analysis of Romania's consolidated general budget deficit level as a GDP ratio, in the interval 1998-2008 and that of other European Union member states. Besides, in table 3 and figures 4 and 5 we notice its evolution, identifying fluctuations from one year to another. Yet, the comparisons will not be limited only to the "classic" European Union members states, because there is also a significant evolution in the consolidated general budget deficit level in the Euro zone and in the states that joined the Union after 2004.

**Table no. 3 The consolidated general budget deficit (-) / surplus (+) level (% GDP) in the interval 1998-2008, in the EU states and Romania<sup>1</sup>**

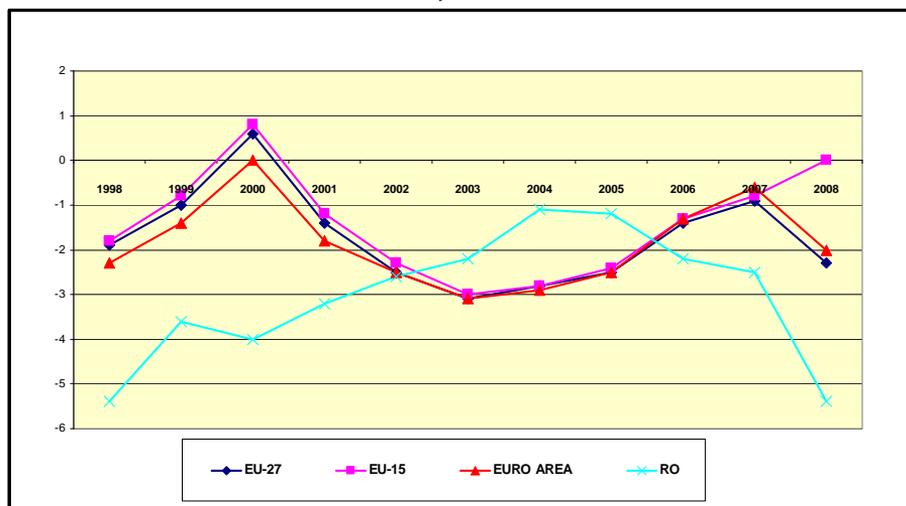
States Reference year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
1	2	3	4	5	6	7	8	9	10	11	12
EU-27	-1.9	-1.0	0.6	-1.4	-2.5	-3.1	-2.8	-2.5	-1.4	-0.9	-2.3
EU-15	-1.8	-0.8	0.8	-1.2	-2.3	-3.0	-2.8	-2.4	-1.3	-0.8	-
EURO AREA <sup>2</sup>	-2.3	-1.4	0.0	-1.8	-2.5	-3.1	-2.9	-2.5	-1.3	-0.6	-2.0
BE	-0.8	-0.5	0.1	0.6	0.0	0.0	0.0	-2.3	0.3	-0.2	-1.2
BG	-	0.2	-0.3	0.4	-1.0	-0.5	1.4	1.8	3.0	0.1	1.8
CZ	-5.0	-3.7	-3.7	-5.7	-6.8	-6.6	-3.0	-3.6	-2.7	-0.7	-2.1
DK	-0.1	1.3	2.2	1.3	0.2	-0.1	1.9	5.2	5.2	4.5	3.4
DE	-2.2	-1.5	1.3	-2.8	-3.7	-4.0	-3.8	-3.3	-1.6	0.2	0.0
EE	-0.7	-3.5	-0.2	-0.1	0.3	1.7	1.6	1.6	2.3	2.6	-2.7
IE	2.4	2.7	4.8	0.9	-0.4	0.4	1.4	1.7	3.0	0.3	-7.2
GR	-2.5	-1.8	-3.7	-4.5	-4.8	-5.6	-7.5	-5.2	-2.9	-3.7	-7.7
ES	-3.2	-1.4	-1.0	-0.6	-0.5	-0.2	-0.3	1.0	2.0	1.9	-4.1
FR	-2.6	-1.8	-1.5	-1.5	-3.1	-4.1	-3.6	-2.9	-2.3	-2.7	-3.4
IT	-2.8	-1.7	-0.8	-3.1	-2.9	-3.5	-3.5	-4.3	-3.3	-1.5	-2.7
CY	-4.1	-4.3	-2.3	-2.2	-4.4	-6.5	-4.1	-2.4	-1.2	3.4	0.9
LV	0.0	-3.9	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.5	-0.3	-4.1
LT	-3.1	-2.8	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.4	-1.0	-3.2
LU	3.4	3.4	6.0	6.1	2.1	0.5	-1.1	0.0	1.3	3.7	2.5
HU	-7.8	-5.4	-3.0	-4.0	-8.9	-7.2	-6.4	-7.9	-9.3	-5.0	-3.8
MT	-9.9	-7.7	-6.2	-6.4	-5.5	-9.9	-4.7	-2.9	-2.6	-2.2	-4.7
NL	-0.9	0.4	2.0	-0.2	-2.1	-3.1	-1.7	-0.3	0.5	0.2	0.7
AT	-2.4	-2.3	-1.7	0.0	-0.7	-1.4	-4.4	-1.6	-1.6	-0.6	-0.4
PL	-4.3	-2.3	-3.0	-5.1	-5.0	-6.3	-5.7	-4.1	-3.6	-1.9	-3.6
PT	-3.4	-2.8	-2.9	-4.3	-2.8	-2.9	-3.4	-6.1	-3.9	-2.6	-2.7
RO	-5.4	-3.6	-4.0	-3.2	-2.6	-2.2	-1.1	-1.2	-2.2	-2.5	-5.4
SI	-2.4	-3.0	-3.7	-4.0	-2.5	-2.7	-2.2	-1.4	-1.3	0.0	-1.8
SK	-5.3	-7.4	-12.3	-6.5	-8.2	-2.8	-2.4	-2.8	-3.5	-1.9	-2.3
FI	1.6	1.6	6.9	5.0	4.1	2.6	2.4	2.8	4.0	5.2	4.5
SE	1.1	1.3	3.7	1.6	-1.2	-0.9	0.8	2.3	2.5	3.8	2.5
UK	-0.1	0.9	3.6	0.5	-2.0	-3.3	-3.4	-3.4	-2.7	-2.7	-5.0

Source: Eurostat; EU Economic Data pocketbook, Quarterly 1-2008, p.76-77; The International Monetary Fund.

<sup>1</sup> The European Union Countries: Belgium (BE), Bulgaria (BG), The Czech Rep. (CZ), Denmark (DK), Germany (DE), Estonia (EE), Ireland (IE), Greece (GR), Spain (ES), France (FR), Italy (IT), Cyprus (CY), Latvia (LV), Lithuania (LT), Luxembourg (LU), Hungary (HU), Malta (MT), The Netherlands (NL), Austria (AT), Poland (PL), Portugal (PT), Romania (RO), Slovenia (SI), Slovakia (SK), Finland (FI), Sweden (SE), The United Kingdom (UK).

<sup>2</sup> The Euro-zone includes 16 countries, beginning with 1 January 2009, due to Slovakia. The data include the Euro-zone 15 countries at the level of 2008, namely: Belgium, Germany, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, The Netherlands, Austria, Portugal, Slovenia, Finland.

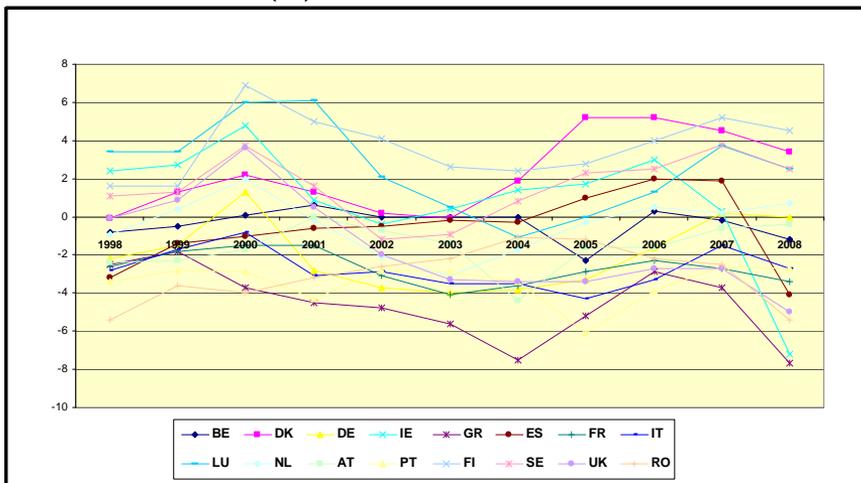
**Figure 4: The consolidated general budget deficit evolution (% GDP) in the UE and Romania, in the interval 1998-2008**



Source: Eurostat; EU Economic Data pocketbook, Quarterly 1-2008, p.76-77; The International Monetary Fund.

We notice that Romania recorded a higher budget deficit than the average of the European Union member states in the interval 1998-2002, and in the interval 2006-2008, as a result of the increase in expenditures on maintaining the government apparatus; of the constant increase in expenditures on reimbursing the public debt; of the increase in inflation and the increase in unproductive expenditures. But between 2002 and 2006, the budget deficit in our country recorded lower values than the budget deficit recorded at European Union level. Regarding the budget deficit evolution at European Union level, the authors noticed insignificant differences in the average of the 27 member states and the states making up the Euro-zone, so that the convergence criterion related to the 3% deficit of the GDP was observed. Moreover, we notice that in 2000 at European Union level a budget surplus was actually recorded.

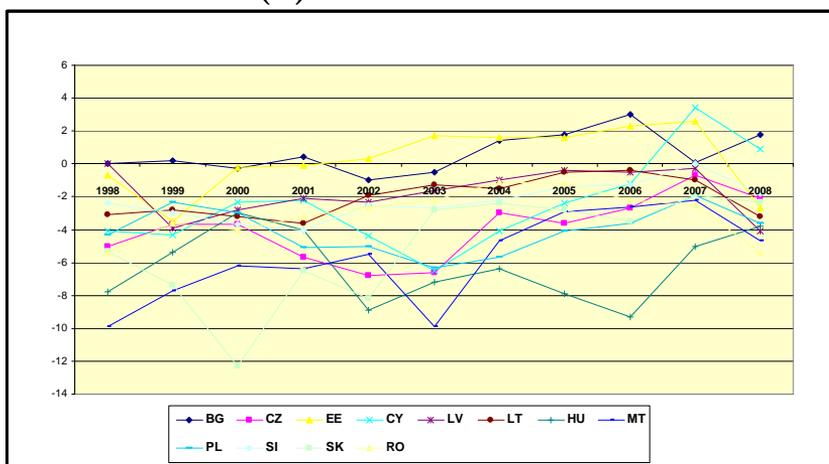
**Figure 5: The consolidated general budget deficit evolution (% GDP) in the EU countries (15) and Romania, in the interval 1998-2008.**



Source: Eurostat; EU Economic Data pocketbook, Quarterly 1-2008, p.76-77; The International Monetary Fund.

In figure 5 we notice that Romania records a lower budget deficit in certain years compared to certain European Union states such as Italy, Greece, Portugal, but a larger one compared to Belgium, Denmark, Luxembourg and the Netherlands. At the level of the 15 European Union countries, the 3% limit set by the Maastricht Treaty regarding the ratio of the budget deficit to the GDP was not observed. Several states even recorded budget surpluses.

**Figure 6: The consolidated general budget deficit evolution (% GDP) in the EU countries (11) and Romania in the interval 1998-2008**



Source: Eurostat; EU Economic Data pocketbook, Quarterly 1-2008, p.76-77; The International Monetary Fund.

In figure 6 we notice that Romania's consolidated general budget deficit, calculated as a ratio to the GDP, is much lower than it is in the other 10 "new" European Union states which joined the EU after 2004. After the analyses and comparisons performed regarding the evolution of the budget deficit in Romania and in other European Union member states, we notice the states' permanent concern with maintaining the budget deficit level according to the Maastricht Treaty requirements of February 1992 and to the Stability and Economic Growth Pact ratified in 1997.

These agreements contain a protocol titled "The Excessive Deficit Procedure" through which the member states must permanently revise, through specific procedures, the budget deficit level according to the GDP and the indebtedness level.

### Conclusions

In our opinion, the monetary policy combined with the fiscal-budgetary policy must aim at covering budget deficits and at decreasing the public debt. In an emerging economy it is important that the fiscal, budget and monetary measures should keep the long-term indebtedness level constant, so that the amount of public debt should increase at the same rate as the nominal GDP. The authors of the research emphasise that the monetary policy must control the inflation, because the inflation rate directly influences the long-term nominal GDP growth rate. We consider that we must envisage an inflation rate that influences a higher nominal GDP growth rate than the interest nominal rate.

Consequently, the monetary policy direction must be supervised permanently, because a high long-term inflation rate leads to an increase in the nominal GDP, thus influencing the increase in the nominal interest rate. Therefore, the budget deficit is influenced by the inflation rate and the interest rate, but on the long term, for a financial stability at state level, two aspects must be monitored related to: the real loan cost and the economy growth rate.

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## **ECONOMIC MEASUREMENTS OF SOCIAL AND INTANGIBLE ASSETS: WHERE DOES ROMANIA STAND AT SUSTAINABLE DEVELOPMENT?**

*Alexandru Ghițiu-Brătescu, Suzana Elena Chiriac, Ioana Maria Ghidiu-Bîta<sup>1</sup>*

### **Abstract**

*Sustainable economic development, no matter the geographical area it is applied to, relates to improving living standards and incorporates a new focus and challenge for the economy: the measurement of intangible and social assets. This article aims to present Romania's ranking among other countries. First of all, it analyses the rationale for measuring social aspects, in the context of the emerging new economy. The essential point here is that investing in intangibles produces more welfare on long term and improves labour productivity, creating a more competitive and knowledge based economy and society. Secondly, several indices are presented and the ranking for Romania is analysed, in order to provide a systematic view and debate upon the importance of social and intangible assets and their ways of measurement at a country level.*

*We consider that our study's results are just a starting point for possible future theoretical and empirical investigations. This paper seeks to develop in Romania a framework of understanding the value of social and intangible assets and their importance for sustainable development. We appreciate that such a study could be a quite useful approach for both the academic and business communities in our country.*

**Keywords:** knowledge economy, intangible assets, sustainable development, economic development, globalisation

**JEL Classification:** A12, A13, F01, F02, J24

### **1. Introduction**

National economies are in a continuous transformation, influenced by globalization and structural change. The focus of this paper is to explore the importance of social and intangible assets and present Romania's position among other countries. The first chapter introduces the rationale for creating a knowledge-based economy and society, referring to the theoretical concepts of the new economy and knowledge economy. Based on this understanding, the second chapter

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explores the main reasons for analysing such assets, referring to practical applications for companies and economies. These relate to the creation of competitive advantage and sustainability. The third chapter introduces three main indicators that are of relevance to our study: the Global Competitiveness Index, the Knowledge Economy Index and the Human Development Index, debating on Romania's rankings and methodology of calculation for each of them.

The paper concludes with a statement for the importance of measuring social aspects over time, in order to provide sustainability and competitiveness on the long run. It also presents a set of recommendations for further improvements, based on the analysis resulted from index's measurements.

## 2. Theoretical rationale for a knowledge-based economy and society

The globalisation process has been an important changes driver in the context of economic development. "Through its increased mobility of capital, workers, goods and services, globalisation is changing the rules by which the economy has been governed during much of the post-war era" [Pike et al., (2006)].

Our society is constantly changing at an increasing speed. We talk more and more about the New Economy or about *Knowledge Economy* which is characterized by a number of factors different from those that characterized the traditional economy.

Some of these features may be referred to as computerization, changing technologies, increasing uncertainty, sustainability, globalization and application of new knowledge. The quality and uniqueness of the knowledge component has become the most important source that someone may have in order to gain a competitive advantage.

The New Economy is developing a global network society where information and communication technologies (ICT) are reshaping communication both within and between organizations. Growing interest on intangible assets is closely related to the development of knowledge society and the undeniable importance of new knowledge-based workers [Porter, (1998)]. In this context, many authors discuss the importance of a firm to survive, highlighting the importance of human and social capital performance within the organization [Kogut & Zander, (1996), Pfeffer, (2002)]. Concepts such as intangible assets, intellectual capital, knowledge creation, basic skills and innovation, are now a centre stage in explaining economic assets that create continuous value to an organization, in exchange for financial and physical resources and gains [Barney, (1991), Ulrich, (1998)].

In a broader perspective, the term knowledge society refers to any society where knowledge is the primary production resource instead of capital or labor. A knowledge society creates, shares and uses knowledge for the prosperity and welfare of the people who belong to it.

Also, lately, the emerging concept of the "new economy" was revealed as a new approach of the economic science. A segment of economists consider that modern economies are dynamic and adaptive systems rather than closed systems struggling

for equilibrium (as they were considered for a long time). Among the strongest supporters is Kenneth Arrow, Nobel laureate and one of the first initiators of the modern neo-classical model and Brian Arthur of the Santa Fe Institute. [Dinu Marin, (2006)].

The specific complexity of the modern economic environment has led some authors to advocate a new approach for the classical economy, and that is for a dynamic and adaptive system. Thus sometimes economists who are studying the new economy have been called “complexity economists”.

In the new economy and knowledge society, intangible assets such as knowledge and information and knowledge management became the new core competencies. Quash, professor at London School of Economics, says that we are in a world that emphasizes the economic value of intangible assets. We are dealing with “cognitive domains” in which ideas are worth billions, while the products still cost less.

In Peter Drucker's vision, the future relies on other key success factors: “the traditional factors of production - land, labour and capital - have not disappeared. But they have become secondary” [Peter F. Drucker, (1993)].

Knowledge, unlike labour, land and capital is an asset that becomes more valuable on the extent of its use. The more used, the knowledge becomes more effective and efficient. Karl Erik Sveiby states that in the new economy, knowledge has four characteristics: knowledge is tacit, is oriented towards action, is based on rules and changes constantly. Knowledge becomes the only resource really relevant today. “The new economy requires a rethinking of the theory of production factors. Knowledge is key component of the system of modern economic and social development. Dissemination of innovation and leading-edge technologies will play a key role in accelerating the importance of knowing the context of globalization” [Karl Erik Sveiby, (1997)].

### **3. Intangible assets – generators of sustainable competitive advantage and convergence**

The new economy involves giving a greater interest to the so-called knowledge society, the employees (who are the holders of knowledge), intellectual capital, intangible assets and learning organizations. A failure to value intangible assets into companies' management and control systems in a systemized way makes sustainable management impossible and endangers the achievement of any company's economic, social, and ecological goals in today's knowledge-based economy.

Without the intangible assets perspective (especially for management and accountability), companies may take the risk of destroying their own core substance for the purpose of optimizing short term financial results. By involuntarily destroying essential intangible assets, they put their value creation and potential for the future at risk.

We see sustainability and intangible assets as two sides of the same coin: intangible assets require a focus on sustainability; whilst sustainability requires the propagation and use of intangible assets. As the Romanian market moves away from a manufacturing-based economy towards a technology-and-innovation driven one, intangible asset investments are becoming vital to economic growth and sustainability.

The E.U. sustainable development strategy promotes “the creation of a prosperous, innovative, rigorous, competitive and eco-efficient economy, which supplies high life standards and fully qualitative employment opportunities throughout the EU” [Council of the European Union, (2006)], thus also emphasising the economic and intangible aspects as important for a sustainable development.

In consequence, sustainable competitive advantage is a central point, if not to say *the core* of both the national and corporate strategy. It allows maintenance and improvement of the company's competitive position in the market and enables the business to survive competitors for a long period of time. Quantitative and qualitative fundamental change in competition requires organizational changes to an unprecedented level. Current sustainable competitive advantage must be built on the organizational capabilities and must be constantly reinvented.

People are key aspects for the evolution of value and *co-creation* of products and services that add value. Their distinctive capabilities are the basis of the competitive advantage. According to the new resource-based perspective of a company, competitive advantage is achieved by continuous developing existing resources and creating new resources and capabilities in response to constantly changing market conditions. Among these resources and capabilities in the new economy, knowledge is the most important value creation asset.

The opportunity to support the organization's competitive advantage is determined by two kinds of capabilities: distinctive capabilities and reproducible capabilities and their unique combination to create synergy [Michael Armstrong, (2004)].

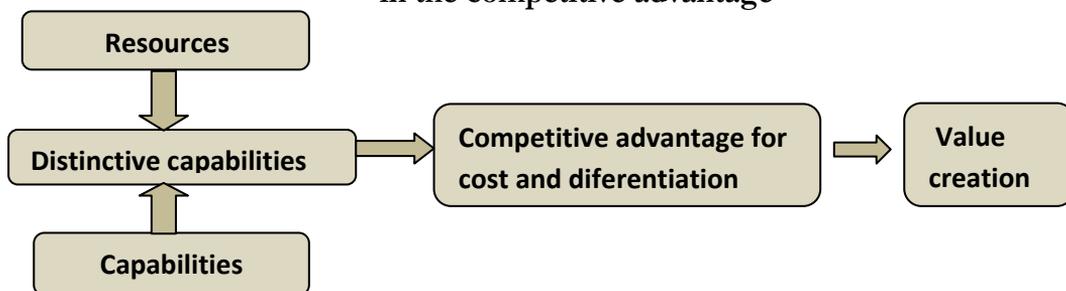
The capabilities are defined as follows:

➤ Distinctive capabilities - are characteristics of the organization that may not be copied by competitors or may be replicated but with great difficulty. They represent the basis of the sustainable competitive advantage.

➤ Reproducible capabilities - are those that can be purchased by competitors and thus can not be a source of competitive advantage. Many financial capabilities, technical and marketing are included in this category.

Therefore, the key point for competitive advantage relies on the manager's or decision maker's ability to choose the pattern or pathway that leads to the creation of value, and not the so-called “destruction of value”, defined by Warren Buffet as a result of irrational policies [Heller R, (2001)]. In practice, a combination of resources and capabilities is needed for value creation, as highlighted by Figure no. 1 below.

**Fig. no.1. Combining the resource based approach and theories regarding the positioning in the competitive advantage**



Source: *Intangible assets and intellectual capital key assets for convergence* (Bucharest, Suci Christina, 2008).

To illustrate the concept of sustainable competitive advantage, it is necessary to appeal to a broad vision that should combine the resources approach with the approach based on the positioning of advantage. Amplifying the importance of intellectual capital reflects an increased dependence on intangible assets of organizations [Michael E. Porter, (1998)].

As the workforce becomes more “global”, value employees and employers are increasingly investing in themselves. This can protect and enhance core competencies. Experts in knowledge are called at an increasingly level to work with individuals in an organization to identify key knowledge assets. To allow increased power is necessary to measure people-centered human resource assets.

We have seen so far the theoretical and practical rationale for analysing the social and intangible assets. They help a company, country and the society to focus on sustainability aspects and lead to the creation of value, which is one of the most important variables for prosperity and success in the new economy. The next section will introduce different rankings for our country relating to three main composite indicators for measurements of the so-called *soft* aspects of an economy.

#### 4. Measuring social and intangible assets

Early since 1990, several indicators that go beyond purely traditional economic measurements, such as a country’s GDP per capita, GNI or PPP have been developed. We shall analyse Romania’s position for three major indicators: the Global Competitiveness Index, the Knowledge Economy Index and the Human Development Index. These three were chosen as they incorporate a broader definition of the wellbeing of a society and economy and all of them include quantifiable measures of innovation and people’s skills.

#### 4.1. The Global Competitiveness Index – Romania's position

Romania is included in assessments related to global competitiveness, based on the Global Competitiveness Report of 2009 - 2010, prepared by the World Economic Forum. The report includes the global competitiveness index, calculated for 133 countries, using data from the year 2008 as a base for estimations. The ranking that the World Economic Forum makes through the Global Competitiveness Report 2009 - 2010 distinguishes three stages of development:

- first, based mostly on endowment with factors,
- second mostly based on efficiency,
- third, based on innovation.

From this perspective, it is considered that Romania is in the transition phase from phase two to phase three of development, ranked 64, which puts us almost at the middle. (Table no. 1)

**Table no.1 The Global Competitiveness Index 2009 – 2010**

Country/economy	Overall Index		Basic requirements (phase I)		Efficiency enhancers (phase II)		Innovation factors (phase III)	
	Rank	Score	Rank	Score	Rank	Score	Rank	Score
Switzerland	1	5,60	3	5,28	3	5,39	3	5,68
United States	2	5,59	28	5,23	1	5,66	1	5,71
Singapore	3	5,55	2	5,99	2	5,61	10	5,15
Sweden	4	5,51	5	5,96	7	5,31	4	5,53
Denmark	5	5,46	4	5,98	6	5,36	7	5,28
Romania	<b>64</b>	4,11	<b>86</b>	4,10	<b>49</b>	4,25	<b>75</b>	3,44
Latvia	68	4,06	60	4,45	51	4,21	86	3,36
Grece	71	4,04	56	4,49	57	4,13	66	3,59
Bulgaria	76	4,02	80	4,13	62	4,08	89	3,29

Source: *The Global Competitiveness Report 2009 – 2010* (World Economic Forum, 2010).

Compared to previous years, when Romania ranked last among the EU member states, this year three EU countries are located under our country as the general level of competitiveness index illustrates in the table. The present situation also provides an opportunity to strengthen economic fundamentals and overall competitiveness in order to put growth on a sustainable footing and prevent future crises.

Since 1998, the OECD (Organization for Economic Cooperation and Development) and the World Bank have cooperated in their activities to create a knowledge-based economy (knowledge for development) and help countries in transition move further to the innovation stage.

The index is calculated from 113 variables, organized into 12 pillars, with each pillar representing an area considered as an important determinant of competitiveness: institutions; infrastructure; macroeconomic stability; health and primary education; higher education and training; goods market efficiency; labour market efficiency; financial market sophistication; technological readiness; market size; business sophistication and innovation.

Relating to Romania's situation as a transition country to the third category of development, as described by the index terminology, Carl Dahlman, Program Manager at the Knowledge for Development in the World Bank Institute stated: "To benefit from the knowledge revolution, concrete strategies are needed to satisfy the four pillars of knowledge economy." [Alberto Rodriguez, Carl Dahlmann (2007)].

The four pillars he refers to relate to institutions, education, information and firms:

- an institutional and economic framework to promote efficient use of knowledge;
- an educated and gifted population to create and use knowledge;
- a dynamic infrastructure for information;
- an effective system of innovation within firms and research centers that can satisfy new needs of the people.

In short, there is no doubt that intangible assets are of main importance for a country's performance. As shown by the data from the Competitiveness Index and the declarations of the specialists from the World Bank Institute of Development, there is a high input that companies and people can make for the economy as a whole. In this respect, Romania has still got some work to do in terms of creating the infrastructure and encouraging research and knowledge spillovers. However, given the current context of the crisis, for the future years we may still expect a drawback in this sense.

## **4.2. The Knowledge Economy Index – Romania's position**

The Knowledge Economy Index (KEI) is a very important tool in our research showing what are the indicators and the current state of a country's convergence towards a knowledge based economy. The index takes into account whether the environment is conducive for knowledge to be used effectively for economic development. It is an aggregate index that represents the overall level of development of a country or region towards the Knowledge Economy [World Bank, (2010)].

The KEI is calculated based on the average of the normalized performance scores of a country or region on all 4 pillars related to the knowledge economy: economic incentive and institutional regime, education and human resources, the innovation system and Information and Communication Technology. (on a scale of 0 to 10 relative to other countries in the comparison group; where 10 represents the score for the top performers and 0 the worst for the laggards).

In comparison to what the Competitiveness Index includes as variables (the official rankings and mostly technical aspects of the economy and market system), the KEI index refers to several qualitative aspects in its measurement (especially interesting are the patents, education enrolment and journals).

Romania positions itself somewhere at the middle also, having a score of 6,43 in 2009 which shows a good improvement in comparison to the 5,48 score it had in 1995. Compared to other EU countries, Romania's overall score is very low. However, in opposition to the situation from previous years measurements, our country has steadily grown for all index's components. The results for Romania are shown in Table no. 2 below.

**Table no. 2 Knowledge Economy Index, 1995, 2008 and 2009**

Country	Knowledge Economy Index (KEI)			Economic Incentive and Institutional Regime			Innovation			Education			Information and Communication Technology (ICT)		
	2009	2008	1995	2009	2008	1995	2009	2008	1995	2009	2008	1995	2009	2008	1995
Netherlands	9.35	9.30	9.49	9.22	9.18	9.50	9.45	9.47	9.52	9.21	9.21	9.68	9.52	9.32	9.24
Spain	8.28	8.21	8.27	8.60	8.58	8.61	8.14	8.13	8.22	8.33	8.32	8.54	8.07	7.81	7.71
Slovenia	8.15	8.27	8.01	8.10	8.11	7.96	8.31	8.31	7.82	8.31	8.26	7.85	7.88	8.42	8.41
Portugal	7.61	7.56	7.87	8.42	8.44	8.63	7.41	7.42	7.36	6.95	6.87	7.45	7.66	7.50	8.02
Slovakia	7.47	7.44	6.94	7.78	7.99	6.38	6.89	6.85	7.02	7.26	7.21	7.16	7.95	7.70	7.18
Poland	7.41	7.52	6.69	7.48	7.39	5.84	7.03	6.91	6.08	8.02	8.82	8.14	7.09	6.95	6.71
Romania	6.43	6.18	5.48	6.98	6.87	5.73	5.74	5.65	4.75	6.47	6.04	6.20	6.55	6.16	n/a

Source: *Knowledge for Development database* (World Bank statistics, 2010).

To better understand in which areas our country still needs improvements as resulted from the calculations of the KEI, we shall detail the composition of each pillar. The Economic Incentive and Institutional Regime takes into account the following:

- tariff & nontariff barriers;
- regulatory quality;
- rule of law.

The Education and Human Resources pillar comprises:

- adult literacy rate;
- secondary enrolment;
- and tertiary enrolment.

The Innovation System holds as variables:

- royalty and license fees payments and receipts;
- patent applications granted by the US Patent and Trademark Office;
- scientific and technical journal articles.

The fourth pillar, Information and Communication Technology, comprises:

- telephones per 1,000 people;

- computers per 1,000 people;
- internet users per 10,000 people.

In 2009, the KEI for Romania is over the world's average (6.43 as against 5.95), the only pillar with a lower score than the world's average being innovation (5.74 as against 8.11). With a KEI in the 6-7 interval, Romania has a medium performance among the EU member states.

The results also confirm the leading position of Denmark and Finland which are, according to various international statistics (e.g. WEF, IMD), among world's leaders in terms of economic competitiveness as well.

Overall, with significant improvements in all four pillars, Romania has markedly improved in the past few years, jumping an impressive 14 spots to rank 48 in 2008 in terms of the KEI, which is a large progress in the rankings among all countries since 1995.

### 4.3. The Human Development Index – Romania's position

The HDI provides a composite measure of three dimensions of human development: living a long and healthy life (measured by life expectancy), being educated (measured by adult literacy and gross enrolment in education) and having a decent standard of living (measured by purchasing power parity, PPP, income)[United Nations Development Programme, (2009)].

The index provides a broadened prism for viewing human progress and the complex relationship between income and well-being.

**Table no. 3 Human Development Index 2009**

HDI value	Life expectancy at birth (years)	Adult literacy rate (% ages 15 and above)	Combined gross enrolment ratio (%)	GDP per capita (PPP US\$)
1. Norway (0.971)	1. Japan (82.7)	1. Georgia (100.0)	1. Australia (114.2)	1. Liechtenstein (85,382)
61. Bulgaria (0.840)	74. Nicaragua (72.7)	30. Cyprus (97.7)	58. Philippines (79.6)	62. Argentina (13,238)
62. Saint Kitts and Nevis (0.838)	75. Saudi Arabia (72.7)	31. Argentina (97.6)	59. Mongolia (79.2)	63. Turkey (12,955)
<b>63. Romania (0.837)</b>	<b>76. Romania (72.5)</b>	<b>32. Romania (97.6)</b>	<b>60. Romania (79.2)</b>	<b>64. Romania (12,369)</b>
64. Trinidad and Tobago (0.837)	77. Jordan (72.4)	33. Mongolia (97.3)	61. Colombia (79.0)	65. Venezuela (12,156)
65. Montenegro (0.834)	78. Dominican Republic (72.4)	34. Israel (97.1)	62. Jordan (78.7)	66. Montenegro (11,699)
182. Niger (0.340)	176. Afghanistan (43.6)	151. Mali (26.2)	177. Djibouti (25.5)	181. Congo (298)

Source: *Human Development Report 2009* (United Nations Development Programme, 2009).

Compared to previous years measurements, Romania was ranked 63 out of the 182 countries measured. (Table no. 3) Note: the data used as a baseline are those from 1990 to 2007, but the report was published in 2009.

Between 1990 and 2007, Romania's HDI rose by 0.37% annually from 0.786 to 0.837. This positions Romania among the countries with a high HDI. According to the report, scores in all regions have increased progressively over the years, although all have experienced periods of slower growth or even reversals. The highest growth rate was registered between 2006 and 2007.

In terms of health status, Romania is positioned with 17 places lower than the average, according to Human Development Report, document published by the United Nations Development Programme that comprises a analysis made on 182 UN member countries. At the E.U. level Romania is similar in what concerns, the structure of development, with Bulgaria, Poland and Hungary.

Poland and Hungary rank higher development (41, 43 respectively) than those for Bulgaria (61) and Romania (63). However, their profiles are very similar in development strategies.

Countries like Romania (placed between positions 1-70) are included in the category countries with a high human development, those in the 71-155 in the countries with medium and the rest have low human development. For Romania, life expectancy at birth increased from 71.9 years to 72.5 years and GDP per capita in purchasing power parity, is at 12,369 dollars. Literacy rate was in 2007, 97.6 percent and the rate of schooling of 79.2 percent from 76.8 percent in the previous report.

Bulgaria is in front of Romania, being ranked 60, and Slovenia, with an index of 0.929, is the state of Central Europe best placed in the UNDP rankings, occupying position 29, followed by Czech Republic - 36, Estonia, Poland, Slovakia and Hungary, which takes place from 40-43, with indexes between 0.883 and 0.879.

## 5. Conclusion

In the third millennium, the organizations worldwide and in Romania as well, must focus on encouraging investments in intangible resources, with the consideration of individual contributions within an organization. As the workforce becomes more “global”, valuable employees and employers should increasingly invest in themselves in order to protect and enhance core competencies and increase the stock of human intelligence through the development of new processes and technologies.

In this context, the factors that influence our lives could be translated as a transition to offering equal importance to economy, environment and society and becoming aware that investments in humans are a main source for a more sustainable economy.

As one of the main conclusions from this paper we see that there is a direct relationship between human capital and firm productivity: employees with high level of training are characterized by a better health status and are the direct source of

innovation, creativity, and therefore competitiveness. Investments in human capital benefit both individuals and society through increased productivity and better organization of economic activity. In the same time, the competitive advantage of a company, public institution or economy and society as a whole, becomes sustainable through the creation of value.

National and local policies in the country play a critical role in allowing optimal human development outcomes both for those who choose to relocate in order to improve living condition and for those who are forced by conflict, environmental degradation or other reasons.

In the same time, the analysis of Romania's positioning among other countries, especially those from the EU, indicates an overall trend of growth in innovation activity. However, there is room for several improvements to be made, especially for infrastructure and technology. Although our country has been registering satisfactory statistics (especially for Human Development), the Competitiveness and Knowledge Economy Indexs show there is room for improvement. In the same time, we must admit that compared to countries such as Norway, France or the United Kingdom, who have long had opportunities and power, it is at least understandable that our country needs to invest more. However, overall, our country has shown an improvement trend for all indexes, thus, in the future the motivational factor for improvement should be sustained, it is the main way to demonstrate our European competitors the value of our people.

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## OIL PRICE AND ITS INFLUENCE ON EUROPEAN ENERGY POLICY

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### **Abstract**

*The purpose of this paper is to assess the influence of oil price on European Energy Policy, taking into account the effects of the current financial crisis on both oil price and European Energy Policy. In order to reach our aim, we made use of thorough research, combined with advanced statistical methods of analysis. The main conclusions drawn from the research undertaken show a certain determination in oil market dynamics and the current economic crisis.*

**Keywords:** oil price, energy policy, financial crisis.

**JEL Classification:** F14, L71, O13, Q31, Q32

### **1. Introduction**

The struggle for energetic resources became more and more intense since the middle of the 20<sup>th</sup> century, generating unexpected consequences in the world economy and geopolitics. The players from “the grand chess board”, as the American analyst Z. Brzezinski named the world scene, build their future strategies according to these resources, considered strategic. Concerns regarding the security of supply generated two main directions of action. One of them manifests itself through an increasing interest for alternative energy sources, such as natural gas and renewable energy technology, which starts to gain momentum. This last course of action is also related to the second direction, i.e. sustainable development and tackling with climate change. Among the leading areas in both directions is the European Union. The history of the EU shows common preoccupations regarding energy from the very beginning of European cooperation, accentuated after the first Oil Crisis. However, despite the many attempts to create a formal energy policy at European level, cooperation in this area is still an intergovernmental process. Events taking place during the last decade gave the European countries a strong incentive to work together and develop a European Energy Policy. The volatility of the crude oil price, as demonstrated in 2008-2009, has also forced governments to take initiatives, thus contributing to increasing the determination at European level to develop a

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common energy policy. A number of questions over how the price of oil is determined and the complex game of interdependencies between the physical and financial markets are raised by recent evolutions on the oil market.

## **2. Energy policies at European level**

Presently, at EU level there already exist a number of energy policies for different domains. We will further present some of them.

### ***SET Plan***

Due to the fact that the seventh Framework Programme (FP7) is mainly devoted to fusion research and that this technology will be unable to help Europe meeting its climate and energy objective until 2050, the European Commission tried to redress this shortfall through the Strategic Energy Technologies Plan (SET Plan). The purpose of the Plan is to enhance coordination of national and EU research and innovation in order to place the EU in the forefront of the low-carbon energy markets. The initiatives proposed by the SET Plan are the European Wind Initiative, the Solar Europe Initiative, the Bio-energy Europe Initiative, the European CO<sub>2</sub> capture, transport and storage initiative, the European electricity grid initiative and the Sustainable nuclear fission initiative

### ***EERA***

The purpose of the European Energy Research Alliance (EERA) is to expand and optimise EU energy research capabilities by sharing top national facilities and jointly realising of national and European programmes. This new Research Alliance will be a key actor of the EU Strategic Energy Technology Plan (SET Plan) and will contribute to accelerate the development of new low carbon technologies for EU to move toward a low carbon economy.

### ***Energy sources***

In October 2001 a Directive on Electricity Production from Renewable Energy Sources obliged the Member States to meet certain targets with respect to renewable energy. The base year was set to 1997, and, although with variations between country targets, the EU must produce of 22% of its electricity from renewable sources by 2010. If the target is reached, the EU will have almost doubled its use of renewable sources in 13 years. Also, the European Commission has proposed a target of 20% renewable energy in the total EU energy mix, to be reached by 2020.

### ***Energy markets***

The EU has also promoted electricity market liberalisation and security of supply through the 2003 Internal Market in Electricity Directive, which replaced early directives in this area. The 2004 Gas Security Directive has been intended to improve security of supply in the natural gas sector.

### ***Transport***

EU policies include the voluntary European Automobile Manufacturers' Association (ACEA) agreement, signed in 1998, to cut carbon dioxide emissions for new cars sold in Europe to an average of 140 grams of CO<sub>2</sub>/km by 2008, a 25% cut from the 1995 level. Because the target was unlikely to be met, the European Commission published new proposals in February 2007, requiring a mandatory limit of 130 grams of CO<sub>2</sub>/km for new cars by 2012, with complementary measures being proposed to achieve the target of 120 grams of CO<sub>2</sub>/km that had originally been expected. In the area of fuels, the 2001 Biofuels Directive requires that 5,75% of all transport fossil fuels (petrol and diesel) should be replaced by biofuels by December 31, 2010, with an intermediate target of 2 % by the end of 2005. In February 2007 the European Commission proposed that, from 2011, suppliers will have to reduce carbon emissions per unit of energy by 1% a year from 2010 levels, to result in a cut of 10% by 2020.

### ***External energy relations***

Beyond the bounds of the European Union, EU energy policy has included negotiating and developing wider international agreements, such as the Energy Charter Treaty, the Kyoto Protocol, the post-Kyoto regime and a framework agreement on energy efficiency; extension of the EC energy regulatory framework or principles to neighbours (Energy Community, Baku Initiative, Euromed energy cooperation) and the emission trading scheme to global partners; the promotion of research and the use of renewable energy. For ensuring efficient follow-up and coherence in pursuing the initiatives and processes, for sharing information in case of an external energy crisis, and for assisting the EU's early response and reactions in case of energy security threats, the network of energy correspondents in the Member States was established in early 2007. After the Russian-Ukrainian Gas Crisis of 2009 the EU decided that the existing external measures regarding gas supply security should be supplemented by internal provisions for emergency prevention and response, such as enhancing gas storage and network capacity or the development of the technical prerequisites for reverse flow in transit pipelines.

## **3. World oil market and the financial crisis**

The oil markets have been transformed radically over the last ten years. Three sub-periods distinguish themselves since the turn of the century (see Figure 1). The first one, 2000-2003, was marked by a relatively stable price, varying between \$22 and \$28, decided by the Organization of Petroleum Exporting Countries (OPEC) as a consequence of the 1998 price collapse. This range was considered neither too low for the exporting countries, nor too high for the world economy. The years between 2004 and 2008, i.e. the second sub-period, are characterized through sharp increases in oil demand since during this period many countries experienced economic booms. The soaring of the oil price towards \$100 did not much affect the world economic growth. The upsurge in the financial markets for oil and commodities lead to an

increasing number of participants, financial products and marketplaces.

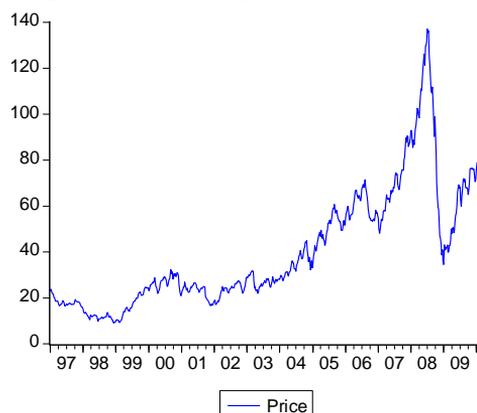


Fig. 1. Weekly world oil price evolution

Consequently, during the last sub-period, that of 2008-2009, the problem of interactions between the physical and financial elements was raised. It is marked by three successive phases: in the first half of 2008, oil prices rose to \$145. This raised certain questions regarding the role played by financial markets. The second half of 2008 brought with itself a plunge in the oil price, reaching \$36., which was caused by the adjustment of the investors' positions and decreasing demand caused by the economic crisis. During 2009, prices rose to 80 dollars which seems contrary to the state of the physical fundamentals, notwithstanding OPEC's production cuts. Determination of oil prices is essentially done on organised futures markets like the American WTI or the European Brent contracts. They take into account both physical and financial fundamentals. Due to the specificities of the two, oil generates two types of demand, i.e. for "physical" oil in the physical market and for "paper" oil in the financial market. It is difficult to establish clear causality links between the open positions of financial investors in futures markets and the prices observed in the spot market, based on the available statistical data.

### 3.1. World Oil Price – A Short Analysis

In order to better understand the evolution of the world oil price, we built an ARIMA model with the help of the Box-Jenkins method.

First, we used the *Census X12* method to remove the seasonal tendency from the series and then tested the seasonally adjusted series for stationarity by using the Augmented Dickey-Fuller unit root test. The series turned out to be not stationary, so we applied the first difference and repeated the test. It resulted that the model to be built should be an ARIMA(p,1,q) one, with no trend and no intercept. Due to the existence of outliers that exert unwanted influence on the analysis, we created a number of dummy variables. Their value is zero, except for the month they were created for. Their inclusion in the model will diminish the error, by allowing the outliers to influence only the months when they were recorded. The outliers were

created for November 2007, May, August, September, October, November and December 2008 and June and November 2009, months for which the variation compared to the previous value was significant. After testing different models, two were chosen as best fitting the trend of the analyzed series, taking into consideration certain criteria. These models are MA(11) and ARIMA(9,1,13). The first model was chosen because of the smallest value for the Akaike criterion, 4.78, and the second one because of the highest value of Adjusted  $R^2$ , 0.7058, but taking into account both criteria. The two models were tested to see whether they fulfil the normality, homoskedasticity and non-autocorrelation of errors conditions. The last stage of the analysis was to predict the value of oil price for February 2010 and compare it with the real one. The obtained predictions were \$76.91 for the first model and \$75.35 for the second one, while the real value was \$73.04. Due to the existence of outliers, which the introduction of dummy variables could not cancel, the model overestimates a little the real price.

The conclusion to be drawn from this analysis is that the second model is more accurate than the first one, fact that could be explained by the higher value of  $R^2$ , which shows how much of the variance is explained by the model. Thus, the model chosen is ARIMA (9,1,13). Also, we have found out that the world oil price is influenced not only by external factors, such as energy policy or economy, but also by past values of oil price itself.

#### **4. An Energy Policy for Europe?**

Despite the fact that the EU has long legislated in this domain, and although it evolved from an energetic cooperation initiative, the idea of a common energy policy at EU level seems to have become a possibility only in 2005, with the occasion of the European Council meeting in London. Relations with the other actors on the energy map, such as producer, consumer and transit countries, gained a great importance from geopolitical and economic perspective starting with 2006. The Commission's Green Paper *A European Strategy for Sustainable, Competitive and Secure Energy* underlined the need for an EU energy policy and established sustainability, competitiveness and security of supply as the three main objectives with respect to energy. Since then, the EU has undertaken dialogues with key energy partners such as Russia, Norway, the U.S., India, China as well as OPEC. Negotiations with Algeria and Iraq have been also carried out, and the European Commission has signed joint declarations on energy with Jordan and Morocco. At the end of the next year, the Commission adopted the 2<sup>nd</sup> Strategic Energy Review, i.e. the EU Energy and Solidarity Action Plan. The main challenges addressed by it are promotion of internal and external infrastructure, which is important for the energetic security of the EU, and ensuring the most effective possible security standards and internal crisis mechanisms security. An example in this sense was the oil and gas crisis caused by disputes between Russia and Ukraine and Belarus. The lesson learnt by Europe during the supply cuts was that the dependency level of the EU needs to be tackled through a suitable external

policy with respect to energy. The Recovery Plan of January 2009 underlines the commitment of the European Commission to enhance energy security. The Plan includes 3.5 billion euro dedicated to investment in infrastructure meant to enhance security of energetic resources in the EU.

## 5. Public opinion

In a poll carried out for the European Commission in October and November 2005, 47% of the citizens questioned in the 27 countries of the EU (including the 2 states that joined in 2007) were in favour of taking decisions on key energy policy issues at a European level. 37% favoured national decisions and 8% wanted that they be tackled locally. A similar survey of 29,220 people in March and May 2006 indicated that the balance had changed in favour of national decisions in these areas (42% in favour), with 37% backing EU policy making and 12% preferring local decisions. There was significant national variation with this, with 55% in favour in the Netherlands, but only 15% in Finland. A comprehensive public opinion survey was performed in May and June 2006. The authors propose following conclusions:

- Energy issues are considered to be important but not at first glance.
- EU citizens perceive great future promise in the use of renewable energies. Despite majority opposition, nuclear energy also has its place in the future energy mix.
- Citizens appear to opt for changing the energy structure, enhancing research and development and guaranteeing the stability of the energy field rather than saving energy as the way to meet energy challenges.
- The possible future consequences of energy issues do not generate deep fears in Europeans' minds.
- Europeans appear to be fairly familiar with energy issues, although their knowledge seems somewhat vague.
- Energy issues touch everybody and it is therefore hard to distinguish clear groups with differing perceptions. Nevertheless, rough distinction between groups of citizens is sketched.

## 6. Conclusions

The importance of energetic resources for the world economy cannot be denied. States build their strategies according to them, are more and more engaged in ensuring themselves the energetic security and seem keener on investing in alternative sources, since the hydrocarbon suppliers are more and more unpredictable. The EU is one of the main players in the area of renewable energy, its policies covering a vast domain, from wind and solar power to nuclear fusion. However, despite numerous attempts to create a common energy policy for the EU, cooperation in the area is still an intergovernmental process. Strong incentives are given to EU members for creating a common energy policy by events taking place on the world oil market,

such as great fluctuations of oil prices, as well as by the geopolitical interests of its suppliers. The financial and economic crisis that affected the world economy since 2007 had effects on the oil market as well. After a period of relatively stable prices varying between \$22 and \$28, the oil prices started to increase. This however did not much affect world economy due to the economic booms experienced by the developing countries and some of the developed ones. However, once financial markets increased both in size and in value, the oil prices started to fluctuate in a range of more than \$100 during 2008 and 2009. A clear distinction should be made between physical oil markets and financial ones. If the first deals with “physical” oil, the second is more concerned about “paper” oil. Also the various interests of the players in these markets must be taken into account. The complexity of interactions between the two types of markets makes it difficult to explain the significant fluctuations of oil price. Also, clear causality links between the positions of investors in the financial markets and the prices on the spot markets are hard to establish based on the available statistical data. A model was built by the authors for the analysis of oil price using the Box-Jenkins methodology. The conclusion to be drawn from this analysis is that the world oil price is influenced not only influenced by external factors, such as energy policy or economy, but also by past values of oil price itself. All these facts have direct influence on European energy policy making. The EU realised that enhancing relations with producer, consumer and transit countries is necessary, but not sufficient in order to ensure its energy security. A common policy is needed in order to tackle certain problems more effectively. As a multinational democracy, the EU must take into account the opinion of its citizens, which it assesses through polls. Slowly, the European public opinion begins to accept the fact that energy policy should be a European matter, rather than a national one, which constitutes a step forward towards development of a European common energy policy. However, this problem should be handled cautiously and bearing in mind that EU member states already proved that they are not ready to give up some of their national attributes in favour of the EU when they rejected the European constitution.

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## OFFSETTING – A METHOD OF SETTLING OBLIGATIONS OF LEGAL ENTITIES

*Ovidiu-Constantin Bunget, Alin-Constantin Dumitrescu\**

### **Abstract**

*Offsetting is a specific method of settling mutual obligations, where the same persons are at the same time creditor and debtor one to another, and by means of which obligations are settled up to the smallest value.*

*Offsetting of mutual obligations is a common way of settling debts, especially in the economic crisis marked by lack of liquidity, among others.*

*There are different offsetting procedures provided by Romanian legislation, according to residence, size of offset amount and state's involvement in the transaction.*

*The analysis of each offsetting situations encountered in the practice of Romanian legal entities, highlights a series of particularities that should be properly considered for their validation.*

**Keywords:** offsetting, residents, non-residents, obligations

**JEL Classification:** M10, M41

### **1. Introduction**

In this article we aimed to analyse the possibilities by means of which a legal entity could reduce receivables / payables disclosed in the financial statements. The research method is based on relevant Romanian legislation and we aimed to disclose to stakeholders the range of tools available to Romanian legal entities.

We consider that our study is also useful in terms of lack of liquidity faced by legal entities in the context of the global economic crisis.

### **2. Definition of obligation**

The Romanian Civil Code (1865), as well as the inspiring European civil codes – the Austrian Civil Code (1811), the Swiss Civil Code (1907) or the Swiss Code of Obligations (1881 and 1911), do not provide a definition for “obligation”. However, there are many definitions in the relevant literature, as follows:

“An obligation represents a legal relationship between two or more persons,

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whereby a party called debtor undertakes to the other party called creditor to perform a positive or a negative activity, i.e. an action or an abstention.”<sup>1</sup>

“An obligation is the legal relationship whereby a person is pledged to give, to do or to not do something in favour of another person.”<sup>2</sup>

“From a legal point of view, an obligation is the relationship whereby a person called creditor may demand from another person called debtor the observance of a certain conduct.”<sup>3</sup>

“An obligation is the legal relationship whereby a person called creditor is entitled to demand from another person called debtor the observance of a certain determinative conduct, which the latter is obliged to fulfil.”<sup>4</sup>

“From a civil point of view, an obligation is the relationship whereby a party called creditor has the possibility to demand from the other party called debtor the observance of one or more actions, such as giving, doing or not doing, usually falling under state compulsion.”<sup>5</sup>

“An obligation is the legal relationship whereby a person called debtor is bound to another person called creditor to the duty of giving, doing or not doing something, under state compulsion in case the action is not executed voluntarily.”<sup>6</sup>

“An obligation is the legal relationship whereby a person called creditor may demand from another person called debtor the observance of a positive or negative conduct, and in case of breach, the creditor may demand satisfaction by constrain.”<sup>7</sup>

“Broadly, an obligation represents the legal relationship which includes the right of the active subject called creditor to demand from the passive subject called debtor to give, to do or to not do something, and where the latter has the corresponding obligation to give, to do or to not do something, under state compulsion in case the action is not executed voluntarily.”<sup>8</sup>

Further to the definitions above it is admitted that the civil obligation represents the legal relationship whereby the creditor is entitled to demand from the debtor the observance of a determinative conduct of giving, doing or not doing something.

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<sup>1</sup> Constantin Hamangiu, I. Rosetti – Bălănescu, Al. Băicoianu - *Tratat de drept civil român*, [Romanian Civil Law], 2nd volume, Națională S. Ciornei Printing House, Bucharest, 1929, page 511;

<sup>2</sup> Tudor R . Popescu, Petre Anca - *Teoria generală a obligațiilor*, [General Theory of Obligations], Științifică Printing House, Bucharest, 1968, page 9;

<sup>3</sup> Renee Sanilevici - *Drept civil. Teoria generală a obligațiilor*, [Civil Law. General Theory of Obligations ], Iași, 1976, page 2;

<sup>4</sup> Ioan Albu, op. cit., page 14;

<sup>5</sup> Liviu Pop - *Teoria generală a obligațiilor*, [General Theory of Obligations], Lumina Lex Printing House, Bucharest, 1996, page 10;

<sup>6</sup> Ion P. Filipescu, Andrei I. Filipescu - *Drept civil. Teoria generală a obligațiilor*, [Civil Law. General Theory of Obligations], Actami, Bucharest Printing House, 2000, page 9;

<sup>7</sup> Ion Dogaru, Pompil Drăghici - *Drept civil. Teoria generală a obligațiilor*, [Civil Law. General Theory of Obligations], All Beck Printing House, Bucharest, 2002, page 10;

<sup>8</sup> Constantin Stătescu, Corneliu Bîrsan - *Drept civil. Teoria generală a obligațiilor*, [Civil Law. General Theory of Obligations], All Beck Printing House, Bucharest, 2002, page 3;

In terms of the existence of a general theory of obligations specific to commercial obligations, there are two main trends. Where autonomy of commercial law is not recognised, e.g. in English or Swiss systems, and where there is a unique “Code of obligations”, it is obvious that the existence of a separate and specific commercial law obligations theory is not recognised. The French, German and Romanian legal systems provide separate legislation for commercial relationships in the form of “commercial codes”, which also highlight particularities of commercial obligations.

The Romanian Commercial Code contains a relatively small chapter called “General information on commercial obligations” (art.46-59), which comprises a series of rules that derogate from the civil law of obligations, especially related to contract execution. Apart from this brief regulation, the Commercial Code also contains a number of rules dedicated to certain contracts, such as sale-purchase agreements, mandate agreements, etc., which are known in civil law as well, but when tailored to commercial needs they show certain particularities. There are also some rules provided by special laws for certain contracts, which have a commercial nature due to their essence and purpose, and which represent an important source for commercial law, such as consignment agreements, leasing agreements, mortgages, franchises, etc.

During their activity traders conclude a number of legal documents or perform commercial activities by means of which certain rights and obligations arise, are amended or settled. Like civil relationships, commercial relationships are also private law relationships. Thus, both commercial and civil relationships are subject to the same general rules provided by the Civil Code. Nevertheless, there are also certain differences between the two legal relationships. These are governed by special rules included in Chapter V “General information on commercial obligations”, Book I of the Commercial Code. The regulation of commercial relationships by both Commercial and Civil Codes is based on art.1 of the Commercial Code, which states that this law is applicable to trade activities. The Civil Code is applicable where the latter does not provide any guidance.

Commercial obligations may arise from legal deeds or actions. Consequently, although commercial obligations may arise from all known civil law sources, contracts are the most important source.

### **3. Methods of settling obligations**

The Civil Code provides the following means of settling civil obligations: direct execution in kind (payment), debt execution enforcement in kind, indirect execution enforcement (by equivalent), offsetting, merger of rights, payment approval, discharge of debt and fortuitous impossibility of execution.

These methods of settling obligations can be classified by two criteria:

By taking into account if obligations were settled with or without the parties’ will:

- Voluntary means of settling obligations: discharge of debt, conventional payment and offsetting

- Means by which obligations are settled without the parties' will: fortuitous impossibility of execution, legal and judicial offsetting, merger of rights

By taking into account if obligations were settled as a result of completion of creditor's receivable:

- Settling methods that result in completion of the creditor's receivable: offsetting, merger of rights, payment approval

- Settling methods that do not result in completion of the creditor's receivable: discharge of debt, fortuitous impossibility of execution

Direct execution in kind (payment) represents the voluntary execution of an obligation by the debtor, regardless of its object, or an agreement between the person making the payment and the one receiving the payment. According to article 1100 of the Civil Code, the creditor cannot be forced to accept something else than what is owed to him, even if the value of that thing would be equal or higher.

According to this article, the debtor must pay exactly the goods or services owed.

Furthermore, according to article 1101 of the Civil Code, the debtor cannot force the creditor to receive a partial payment, even if the obligation is divisible. This means that payment must be made in full.

Debt execution enforcement in kind allows the creditor to resort on means made available by law in order to force the debtor who did not perform the payment voluntarily to fulfil his obligations, in principle, as it was undertaken, thus enabling the creditor to capitalize his patrimonial right. The debtor is pledged to actually perform the obligation that he has undertaken.

Should the execution in kind no longer be possible, then the execution by equivalent in the form of offsetting will be enforced.

Indirect execution (by equivalent) represents the creditor's right to demand and obtain from the debtor the equivalent of the prejudice incurred due to non-performance, late or improper performance of the undertaken obligation.

This means that when it is no longer possible to execute the obligation in kind, the creditor is entitled to compensations or indemnifications, which represent the equivalent of the incurred loss.

Compensations or indemnifications are of two kinds:

- compensatory payments – the equivalent of the loss incurred by the creditor due to non-execution or partial execution of the obligation;

- equivalent compensations – the equivalent of the loss incurred by the creditor due to late execution of the obligation; these compensations may be cumulated with execution in kind, unlike compensatory payments that replace execution in kind.

Offsetting represents a specific method of settling mutual obligations, whereby the same persons are at the same time creditor and debtor one to another, and

obligations are settled up to the smallest value.

Merger of rights is a method of settling obligations, whereby the same person is creditor and debtor of the same obligation. Merger of rights applies to all contractual or extra-contractual obligations between individuals and legal entities. It settles the obligation with all its guarantees and accessories.

Payment approval is defined as the method of settling obligations whereby, at debtor's proposal, the creditor accepts to receive another benefit instead of the one undertaken at the conclusion of the agreement. According to article 1100 of the Civil Code, the creditor's consent is required in order to proceed this way.

Discharge of debt means that the creditor gives up for free on his right to value the receivable against his debtor. In other words, discharge of debt represents a voluntary method of settling obligations, whereby the creditor gives up his right, with the debtor's consent. Discharge of debt is covered in articles 1138 – 1142 of the Civil Code.

Fortuitous impossibility of execution by the debtor is a method of settling obligations, which operates due to the fact that the debtor is in absolute impossibility of executing his obligation out of force majeure reasons. This method of settling obligations is covered in article 1156 of the Civil Code.

#### **4. Procedures for offsetting mutual obligations between legal entities**

Mutual obligations between legal entities may be settled by offsetting. The actual transaction varies according to residence, the amount to be offset and the state's participation in the transaction.

##### ***4.1. Offsetting between residents***

###### ***4.1.1. Prerequisites***

Offsets between Romanian legal entities are based on offsetting orders, according to Government Decision no. 685/1999 for approving the methodological norms for monitoring debts of corporate taxpayers that are outstanding at maturity date, in order to reduce financial blockage and economic losses ("GD 685/1999"), the Regulation for offsetting debts of corporate taxpayers that are outstanding at maturity date, respectively Emergency Ordinance no. 77/ 1999 on measures for preventing payment default (approved by Law no. 211/2001).

Offsetting of mutual debts is subject to offsetting regulations, based on offsetting orders. Before describing the offsetting procedures, we should clarify the following terms:

a) *non-cash offsetting* – settlement of mutual obligations between two or more legal entities based on offsetting orders, up to the smallest obligation.

b) *offsetting of small amounts* – cancellation of mutual payment obligations below RON 10,000.

c) *closed successive offsetting* – offsetting of obligations resulting from economic transactions of previous periods, which settles debts existing at a certain moment between the parties.

d) *open successive offsetting* – offsetting of obligations resulting from economic transactions between two or more legal entities, for existing liabilities recorded in accounts, except for those that have been brought in courts.

Debts outstanding at maturity date for invoices over RON 10,000 and older than 30 days can be offset only through the Offsetting Department of the Management and Informatics Institute.

For amounts below RON 10,000 inclusively, offsets between corporate taxpayers can be made also without the Offsetting Department of the Management and Informatics Institute, but only based on special offsetting orders.

The offsetting procedure presumes a couple of transactions to be performed by legal entities requesting an offset of obligations. They are required to use the internet or magnetic devices in order to send to the database of the Management and Informatics Institute the data regarding payments older than 30 days and with a value higher than RON 10,000, as well as the offsetting claims comprising the situation of outstanding receivables and payables. The transmission of data regarding payables and receivables can be made by using the internet addresses <http://gama.imi.ro> or [www.minind.ro](http://www.minind.ro), and then they have to chose the menu “Hosted Pages – Portal on offsetting receivables”. For invoices that fall under these conditions the following information should be transmitted:

- tax code of the reporting legal entity,
- tax code of the legal entity - creditor/debtor - towards which the reporting entity has a payment/collection relationship,
- number and date of the invoice issued by the creditor/debtor,
- value of the invoice to be collected by the reporting legal entity from the beneficiary legal entity,
- value of the invoice to be paid by the reporting legal entity to the providing legal entity,
- volume of loans not reimbursed by financing banks at maturity date, including interest,
- volume of outstanding payables to state budget, local budgets, social security budget and special funds budgets, including late payment penalties, as appropriate,
- volume of receivables from legal entities that are fully or partially financed from the state budget,
- volume of loans granted by companies and not repaid at maturity date.

Legal entities that do not have receivables or payables older than 30 days and with a value higher than RON 10,000 lei are not required to send information, but if they want to register with the offsetting system they can also send invoices under 30 days, with values below RON 10,000.

Subsequent to introducing the data above in the system, legal entities must

update all changes permanently, at intervals not exceeding 30 days.

#### *4.1.2. Offsetting regulations*

According to GD no. 685/1999 for approving the methodological norms for monitoring debts of corporate taxpayers that are outstanding at maturity date, in order to reduce financial blockage and economic losses, offsets are based exclusively on offsetting orders, which are special documents, numbered by the printing house, kept with strict evidence. In any case, regardless of the outstanding amount, it is forbidden to use other offsetting documents than those provided in the offsetting regulations.

Offsetting orders issued by the Offsetting Department represent supporting documents for registration in accounts of settlement of receivables and payables which have been offset (e.g. 401 Suppliers = 411 Clients). Offsetting orders are attached to accounting bills.

In order to accomplish offsets, subsequent to submitting the data to the Management and Informatics Institute (IMI), legal entities involved or IMI should find a circuit for settling mutual debts. The offsetting inspector appointed by the initiating legal entity by means of a proxy shall come to IMI for closing the documents.

The offsetting meeting takes place at IMI within 3 days after finding the offsetting circuits. The daily meeting ends by mentioning in the minute of meeting (as set out in appendix no. 2.3 of GD no. 685/1999) of all legal entities and amounts involved in the offsetting. The minute of meeting shall be signed for each circuit by the legal entities' representatives and by the offsetting agent appointed by the Offsetting Department, and offsetting orders shall be prepared based on the appendix (as set out in appendix no. 2.1 of GD no. 685/1999). One offsetting order is sent to each legal entity, by mentioning the amount offset with each legal entity.

#### *4.1.3. Records of offsetting transactions*

This is done within the Offsetting Department by means of the Offsetting Transactions Register (as set out in appendix no. 2.4 of GD no. 685/1999). This register should contain chronologically:

- the offsetting date,
- the minutes of the meetings containing the legal entities involved in the offsetting and the amount offset for each relationship,
- record of offsetting orders issued to each legal entity, with their number and value.

#### *4.1.4. Dispute resolution and error correction*

Disputes shall be solved on days when offsetting meetings are scheduled, by offsetting inspectors who represent the legal entities in the dispute. A minute shall be prepared in order to foresee the measures to be taken by the parties.

Errors shall be solved at the request of the respective legal entity, by analysing the nature of the error and its financial impact for the petitioner. If the parties fail to agree on how to offset payment obligations, the offsetting does not come into effect. If the error impacts on more legal entities, the Offsetting Department will send to all parties involved the corrections to be made, as follows:

- typo errors (incorrect figures) - the document shall be presented in original for cancellation and another correct offsetting order will be issued;
- wrong name of the legal entity with which the offset was made – the respective offsetting order will be cancelled and another offsetting order will be issued.

Replacing documents are effective from the same date as initial documents. Correction documents shall be recorded in a special register by the offsetting agent, signed by the Offsetting Department and by two or more involved offsetting agents.

## ***4.2. Offsetting between a resident and a foreign legal entity***

### *4.2.1. Considerations on offsets between a resident and a foreign legal entity*

Residents are defined as follows:

- individuals – Romanian nationals, foreign nationals and stateless persons residing in Romania, confirmed with identification documents issued according to the law;
- legal entities established in Romania, as well as individuals - Romanian nationals, foreign nationals and stateless persons residing/domiciled in Romania – who are authorised and/or registered to conduct independent business activities in Romania,
- branches, agencies, representative offices of foreign legal entities, as well as of any other foreign entities registered and/or authorised to operate in Romania,
- embassies, consulates and other representative offices and permanent missions of Romania abroad.

Non-residents are defined as follows:

- individuals – foreign nationals, Romanian nationals and stateless persons residing abroad, confirmed with identification documents issued according to the law,
- legal entities established abroad, as well as individuals - foreign nationals, Romanian nationals and stateless persons residing abroad – who are authorised and/or registered to conduct independent business activities abroad, as provided by

the regulations in force,

- branches, agencies, representative offices of Romanian legal entities, as well as of any other Romanian entities registered and/or authorised to operate abroad,
- embassies, consulates and other representative offices and permanent missions of other states in Romania, as well as international organisations or representative offices of such organisations that operate in Romania.

Offsets of mutual payables/receivables between a resident and a non-resident legal entity do not fall under the provisions of GD no. 685/1999, and in these cases common law provisions of the Civil Code (art. 1091, art. 1143-1153) are applicable.

In order to register them in accounting, the parties should conclude offsetting transactions in writing. The document should contain the dates of the invoices and of other documents related to the amounts to be offset (offsetting order set out in GD no. 685/1999).

#### 4.2.2. Reporting of performed offsets

Offsets of receivables between resident entities performing direct non-monetary transactions with non-resident entities (and not through financial institutions) must be reported to the Statistics Department of the National Bank of Romania. Such offsets are governed by Regulation no. 26/2006 of the National Bank of Romania on statistical reporting of data for the preparation of payment balances, with amendments provided by NBR Regulation no. 12/2009.

Such offsets are non-monetary transactions of the nature of payment balances, taking place without a transfer of funds (e.g. offset of exports with imports or the other way round), and reporting is done on a form for each transaction type.

#### 4.3. *Offsetting of payables with receivables against state budget*

The offset is accomplished when a taxpayer is both debtor and creditor in relationship with the state budget<sup>9</sup>. In other words, the offset is performed between the taxpayer's receivables representing amounts to be reimbursed and the receivables managed by the Ministry of Economy and Public Finance, when in mutual relationships both parties are debtor and creditor.

The offset is done up to the smallest value of receivables and payables existing between the two parties and it can be initiated as follows:

- by the taxpayer at his request;
- by the tax authority automatically or whenever there are mutual receivables, except for negative VAT amounts without refund option; the legal provision on automatic offsets is not imperative, because according to the Tax Procedure Code, the tax control body “may” do such offsets; consequently, taxpayers should not rely

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<sup>9</sup> Bunget Ovidiu Constantin, Peres Ion – *Control financiar*, [Financial Control], West University Printing House, Timisoara, 2010, page 152;

on tax authorities' initiative and it would be advisable to initiate the offsets themselves.

The following steps are made for an offset:

- i) payables to the same budget are offset first;
- ii) subsequently, within the remaining difference, taxpayer's payables to other budgets will be offset proportionally, in the following order:
  - state budget;
  - risk fund for state guarantees on foreign loans;
  - social security budget;
  - unique national budget for health insurance;
  - unemployment budget.

Tax receivables deriving from customs relationships are offset with debtor's receivables representing amounts of the same nature to be refunded. Any remaining differences will be offset with other tax payables of the debtor, in the order required by law.

Regardless of how it was initiated, within 7 days the offset is followed by the written notification of the taxpayer on the measures taken in this respect.<sup>10</sup> Nevertheless, the Tax Procedure Code does not provide this obligation for automatic offsets.

#### *4.4. Offsetting of payables with receivables against local budgets*

Currently (June 2010), receivables/payables to the state budget cannot be offset with receivables/payables to local budgets.

However, in April 2010, the Romanian Senate adopted a bill for amending the Tax Procedure Code, which provides that certain amounts to be received by the taxpayer from the budgets of local public institutions/tax authorities will be offset with taxpayer's payables, respectively amounts not paid by the state due to the fact that they were not transferred from the state budget to the local budgets (these amounts represent the value of goods delivered or services rendered by the taxpayer for public investments). This bill is currently with the Chamber of Deputies, and has already been approved by the Budget-Financing Commission.

### *Conclusions*

The analysis of various situations in which legal entities can offset receivables with payables that they have against other legal entities (resident or non-resident) or against the state, makes us to consider that this transaction should be performed with courage, thus contributing to decrease of debts and financial blockage that occur during the current economic crisis. The set-up and development of a company implies contributions required for financial support of assets necessary for business

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<sup>10</sup> Government Ordinance no. 92/2003 on Tax Procedure Code, republished, art. 112, para. 7;

activity based on strategic decisions. Usage of various financial sources based on their costs, access and availability, generates both direct (by size and duration of undertaken debts) and indirect (by resource costs) effects on net assets.<sup>11</sup>

Without being considered a routine method of settling receivables and payables or a method that depends on barter economy, in the context of liquidity crisis, offsetting can be considered a customary method in the practice of legal entities in Romania.

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<sup>11</sup> Monica Petcu, Iulia David – *Analiza economico-financiara – Analiza patrimoniului net*, [Economic-Financial Analysis. – Net Asset Analysis], Economica Printing House, Bucharest, 2007, page 76

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**PRINCIPLES OF TQM IN AUTOMOTIVE INDUSTRY**

Nicoleta Isac\*

**Abstract**

*TQM refers to a management process and set of disciplines that are coordinated to ensure that the organization consistently meets and exceeds customer requirements. TQM engages all divisions, departments and levels of the organization. TQM companies are focused on the systematic management of data in all processes and practices to eliminate waste and pursue continuous improvement. The goal is to deliver the highest value for the customer at the lowest cost while achieving sustained profit and economic stability for the company. While every organization should implement its own specialized form of quality management, there are some basic core principles that guide every quality effort. The single most important element of quality management is the focus on the customer. During this quality process, we will strive frequently to hear from our customers. From this basic concept, that the customer is the ultimate determiner of quality, come the other principles of Quality management. All types of automotive industries, have reduced costs increased process efficiency and improved the quality of their products and services by working to meet the needs of the people they serve through the application of total quality management (TQM) principles. Learning the principles and practices of TQM will help achieve outstanding results and enlist the support of top management in advancing this concept within the organization enabling area managers or supervisors to create a work environment that gets the best from its workers. The proof will be reflected in the results deliver to the customer. With growing global competition, quality management is becoming increasingly important to the leadership and management of automotive industry. Quality management principles provide understanding of and guidance on the application of quality management. By applying following quality management principles, organizations will produce benefits for customers, owners, employees, suppliers and society as a whole.*

**Keywords:** management, total quality management, automotive industry

**JEL Classification:** L15, L62

**Introduction**

Total Quality Management is a management approach that originated in the 1950's and has steadily become more popular since the early 1980's. Total Quality is a description of the culture, attitude and organization of a company that strives to provide customers with products and services that satisfy their needs. The culture requires quality in all aspects of the company's operations, with processes being done right the first time and defects and waste eradicated from operations.

Total Quality Management, TQM, is a method by which management and employees can become involved in the continuous improvement of the production

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of goods and services. It is a combination of quality and management tools aimed at increasing

business and reducing losses due to wasteful practices. Some of the companies who have implemented TQM include Ford Motor Company, Motorola and Toyota Motor Company. Today, high quality is absolutely essential to meet customer requirements. The TQM principles express the basic ideas and in this case the specialists have relatively different points of view. J. Juran formulates the following principles: client orientation, competitiveness, continuous quality improvement, client-supplier relations internalization, top management involvement. G. Merli places at the basis of TQM the following principles: clients' satisfaction, quality on the first plan, involvement of the entire personnel, continuous improvement. Analyzing other opinions as well we note nevertheless that the majority of specialists agree with the following principles which are at the basis of TQM:

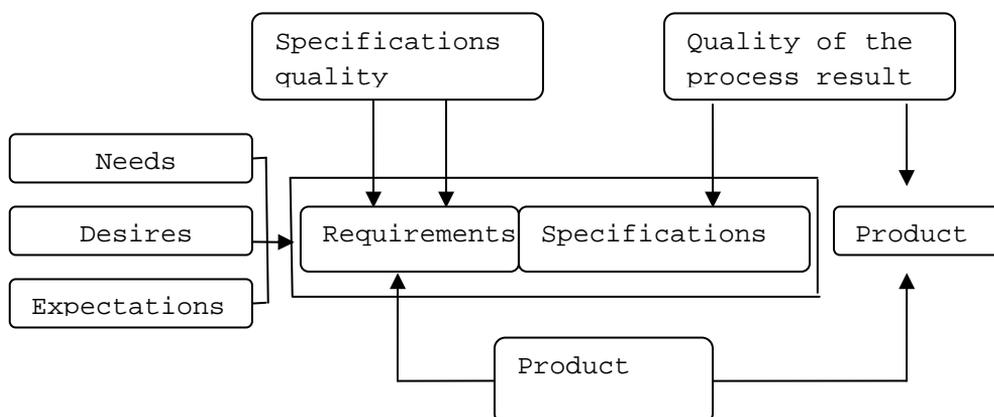
***Table 1: Concepts of TQM Philosophy***

Concept	Main idea
Customer focus	Goal is to identify and meet customer needs
Continous improvment	A philosophy of never – ending improvement
Employee empowerment	Employees are expected to seek out, identify, and correct quality problems
Use of quality tools	Ongoing employee training in the use of quality tools
Product design	Quality should be built into the process; sources of quality problems should be identified and corrected
Managing supplier quality	Quality concepts must extend to a company's suppliers

### **Customer focus**

The first and the most important characteristic of TQM is the attention granted by the company to the clients. Within the automotive industry as well, quality must satisfy and overcome clients' expectations. The purpose is the identification, then the meeting of all client's needs. TQM admits that a perfectly built product has a reduced value as long as it is not what the client desires. This is why we say that the quality level is granted by the client. In any case, it is not always easy to determine what a client desires, because the tastes and preferences change. Also, clients' expectations vary from a client to another. For example, in the automotive industry, the preferences change fast, from small cars to four-wheel drive vehicles and then back

to small cars. The companies must gather information constantly, by research groups, market studies, and meetings with clients, in order to remain close to clients' tastes.



*Figure 1. The relation between product quality and specifications quality (Source: Total Quality Management, Marieta Olaru - ASE Bucharest)*

In the automotive industry the main benefits for applying this principle are the following:

- Increased revenues and market quota obtained through flexibility and a quick answer related to the market opportunities
- Increased effectiveness regarding the use of the organization resources in order to increase clients' satisfaction
- The improvement of clients' loyalty degree which has as a result repetitive business transactions.

The application of this principle will lead to:

- Researching and comprehending client's needs and expectations
- Assuring the fact that the organization objectives are correlated with clients' needs and expectations
- Communicating these needs and expectations within the organization
- Measuring clients' satisfaction and acting according to the obtained results
- The systematic management of the relation with the clients

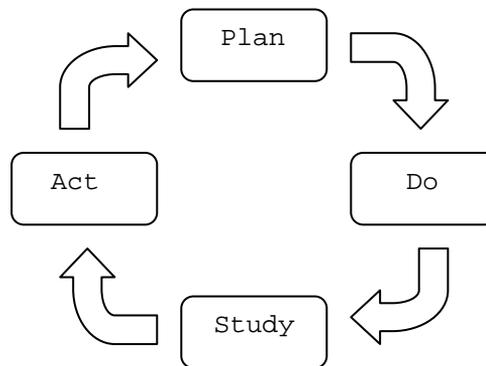
### **Continuous improvement**

Customer's expectations are always changing and typically rising as quality management begins to yield results. It is important to remember that when customers are assessing quality, they are not simply comparing us to our performance last year, but to every other organization that is serving their needs; from the Department of Motor Vehicles to the supermarket. (2001 B. Abohmed). TQM is mainly concerned with continuous improvement in all work, from high level strategic

planning and decision-making, to detailed execution of work elements on the shop floor. It stems from the belief that mistakes can be avoided and defects can be prevented. It leads to continuously improving results, in all aspects of work, as a result of continuously improving capabilities, people, processes, technology and machine capabilities. Continuous improvement must deal not only with improving results, but more importantly with improving capabilities to produce better results in the future.

One of approaches that can help companies with continuous improvement: the plan –do– study – act (PDSA) cycle and describes the activities a company needs to perform in order to incorporate continuous improvement in its operation. The circular nature of this cycle shows that continuous improvement is a never-ending process. Let's look at the specific steps in the cycle. **Plan** The first step in the PDSA cycle is to plan. Managers must evaluate the current process and make plans based on any problems they find. They need to document all current procedures, collect data, and identify problems. This information should then be studied and used to develop a plan for improvement as well as specific measures to evaluate performance.

**Do** The next step in the cycle is implementing the plan (do). During the implementation process managers should document all changes made and collect data for evaluation. **Study** The third step is to study the data collected in the previous phase. The data are evaluated to see whether the plan is achieving the goals established in the plan phase. **Act** The last phase of the cycle is to act on the basis of the results of the first three phases. The best way to accomplish this is to communicate the results to other members in the company and then implement the new procedure if it has been successful. Note that this is a cycle; the next step is to plan again. After we have acted, we need to continue evaluating the process, planning, and repeating the cycle again.



**Figure 2. Plan - Do - Study - Act**

The main benefits in applying this principle in the automotive industry are:

- The alignment of the improved activities, at all levels, with the strategic intentions of the organizations
- The flexibility to react rapidly at the occurrence of any opportunities

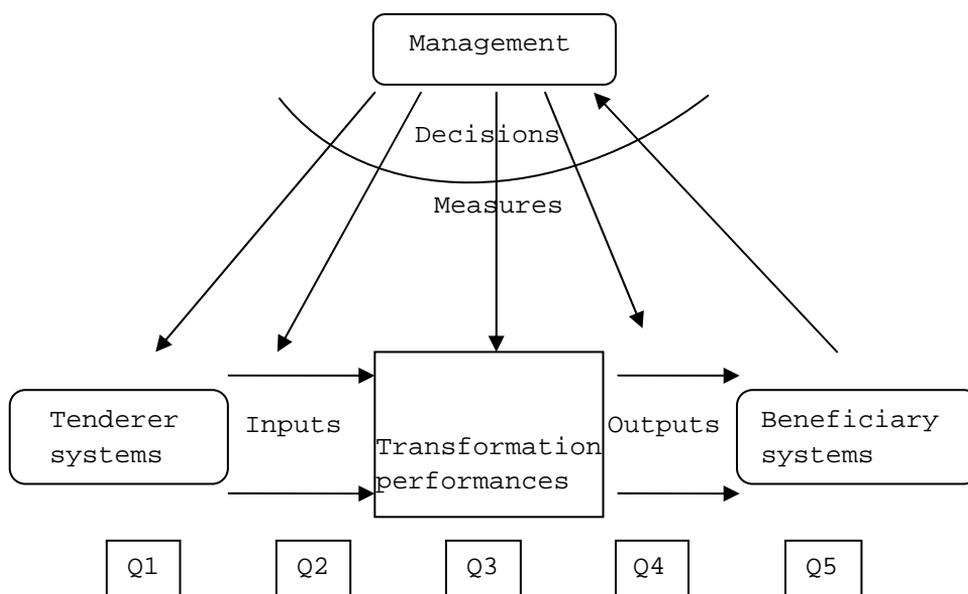
The application of this principle will lead to :

- The existence of a consequent approach at the level of the entire organization for the continuous performances improvement
- The assurance for the organization employees of an adequate training regarding the methods and instruments for the continuous improvement
- The establishment of specific objectives able to guide the continuous improvement and of certain actions able to provide the continuous improvement follow-up

### Employee empowerment

Employee involvement evolved out of business's need to improve performance. The impact of human resources in the organization depends on the kind of empowerment given to them. In TQM, the role of employees is very different from what it was in traditional systems. Workers are empowered to make decisions relative to quality in the production process. They are considered a vital element of the effort to achieve high quality. Their contributions are highly valued, and their suggestions are implemented. In order to perform this function, employees are given continual and extensive training in quality measurement tools.

Making the decisions within the organization represents a process of logic activities by which you chose a variant of action from several possible. According to this principle, the effective decisions are underlain on complete and safe information, which are analyzed logically and intuitively.



*Figure 3. Key Quality Checkpoints (Source: Total Quality Management, Marieta Olaru - ASE Bucharest)*

The perception (comprehension) of clients' needs and their complete reflecting in the finished products quality (Q5), must constitute the basis of the decisions and measures in all the other points of the system (Q1...Q4).

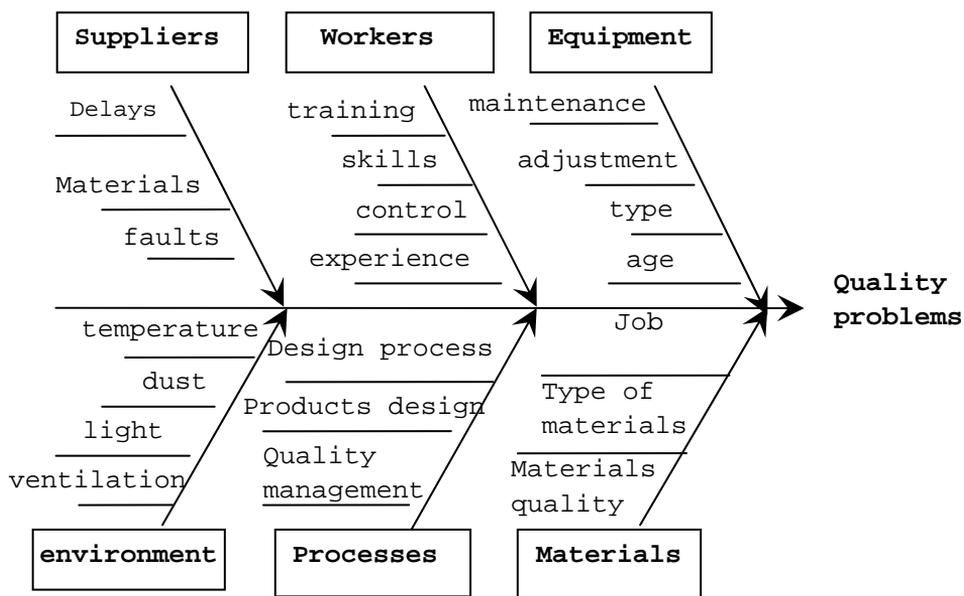
The main benefits of this principle application are :

- Decisions based on information
- An increased ability to demonstrate the effectiveness of the previous decisions by reference to real records

### **Use of quality tools**

TQM places a great deal of responsibility on all workers. If employees are to identify and correct quality problems, they need proper training. They need to understand how to assess quality by using a variety of quality control tools, how to interpret findings, and how to correct problems. These are sometimes called the seven means for quality control ( cause and effect diagrams, Scatter diagram, flowcharts, Pareto chart, Histogram, Control charts, checklist).They are easy to understand and at the same time extremely useful in the quality problems identification and analysis. Sometimes, the employees use one mean, but often, the use of a combination of means is of greater help. We will further refer to three of the seven means of quality control, namely the cause and effect diagram, the checklist and the control charts.

Cause-and-effect diagrams are charts that identify potential causes for particular quality problems. They are often called fishbone diagrams because they look like the bones of a fish. A general cause-and-effect diagram is shown in Figure . The "head" of the fish is the quality problem, such as damaged zippers on a garment or broken valves on a tire. The diagram is drawn so that the "spine" of the fish connects the "head" to the possible cause of the problem. These causes could be related to the machines, workers, measurement, suppliers, materials, and many other aspects of the production process. Each of these possible causes can then have smaller "bones" that address specific issues that relate to each cause. For example, a problem with machines could be due to a need for adjustment, old equipment, or tooling problems. Similarly, a problem with workers could be related to lack of training, poor supervision, or fatigue. Cause-and-effect diagrams are problem-solving tools commonly used by quality control teams. Specific causes of problems can be explored through brainstorming.

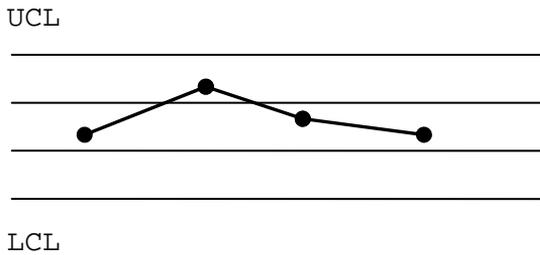


*Figure 4. Cause-and-effect (fishbone) diagram ( Source: [www.wiley.com/college/sc/reid/chap5](http://www.wiley.com/college/sc/reid/chap5) )*

*Checklist* - In automotive industry checklist facility owners, and technicians, determined there was a need for compliance assistance to automotive repair shops to help them attain or remain in compliance with applicable environmental regulations.

*Control charts* - These charts are used to evaluate whether a process is operating within expectations relative to some measured value such as weight, width, or volume. For example, we could measure the width of a tire. When the production process is operating within expectations, we say that it is “in control”.

To evaluate whether or not a process is in control, we regularly measure the variable of interest and plot it on a control chart. The chart has a line down the center representing the average value of the variable we are measuring. Above and below the center line are two lines, called the upper control limit (UCL) and the lower control limit (LCL). As long as the observed values fall within the upper and lower control limits, the process is in control and there is no problem with quality. When a measured observation falls outside of these limits, there is a problem.



*Figure 5.: Control Diagram*

### **Product design**

A critical aspect of building quality into a product is to ensure that the product design meets customer expectations. This typically is not as easy as it seems. Customers often speak in everyday language. For example, a product can be described as “attractive,” “strong,” or “safe.” However, these terms can have very different meaning to different customers. What one person considers to be strong, another may not. To produce a product that customers want, we need to translate customers’ everyday language into specific technical requirements. However, this can often be difficult. A useful tool for translating the voice of the customer into specific technical requirements is quality function deployment (QFD). Quality function deployment is also useful in enhancing communication between different functions, such as marketing, operations, and engineering. QFD begins by identifying important customer requirements, which typically come from the marketing department. These requirements are numerically scored based on their importance, and scores are translated into specific product characteristics. Evaluations are then made of how the product compares with its main competitors relative to the identified characteristics. Finally, specific goals are set to address the identified problems. The resulting matrix looks like a picture of a house and is often called the house of quality.

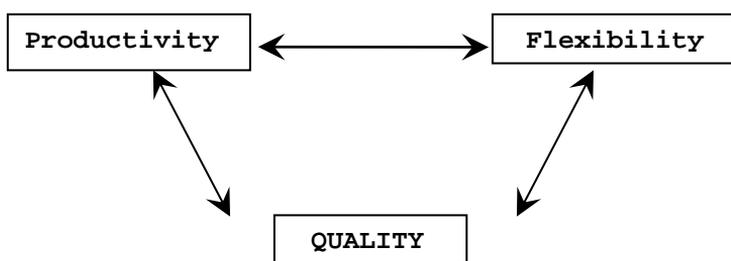
QFD enables us to view the relationships among the variables involved in the design of a product, such as technical versus customer requirements. This can help us analyze the big picture—for example, by running tests to see how changes in certain technical requirements of the product affect customer requirements. An example is an automobile manufacturer evaluating how changes in materials affect customer safety requirements. This type of analysis can be very beneficial in developing a product design that meets customer needs, yet does not create unnecessary technical requirements for production. Figure 5 displays three important production system design objectives: productivity, flexibility and quality. In traditional production system design, the sole objective was productivity in terms of cost-per-unit or worker-hours-per-unit. Recently, the value of flexibility has been recognized and often takes an explicit role in production system design.

First, to refute the theory that quality is wholly determined by product design, we present two pieces of evidence from the Ford Motor Company that demonstrate that the production system affects quality. Later exhibits will more specifically address production system design.

#### *Jaguar*

After Ford acquired Jaguar, Jaguar's quality improved rapidly. Smith (2001) attributes this quality improvement to Ford adopting Toyota's production process at the Jaguar plant. These improvements were not due to product design changes, but to production system changes, which indicates that the production system affects quality.

#### *Designing production systems for quality*



*Figure 5. Competing objectives in production systems design ( Source: Designing production systems for quality: research opportunities from an automotive industry perspective )*

#### *Ford parts suppliers*

Wilson and Sedgwick (2002) report that Ford analysed incidents when defective purchased parts caused Ford to halt shipments of vehicles, and that Ford concluded that 'manufacturing problems caused 83 percent of these incidents, while design problems caused 17 percent.'

### **Proces management**

According to TQM a quality product comes from a quality process. This means that quality should be built into the process. Quality at the source is the belief that it is far better to uncover the source of quality problems and correct it than to discard defective items after production. If the source of the problem is not corrected, the problem will continue. Quality at the source exemplifies the difference between the old and new concepts of quality. The old concept focused on inspecting goods after they were produced or after a particular stage of production. If an inspection revealed defects, the defective products were either discarded or sent back for reworking. All this cost the company money, and these costs were passed on to the

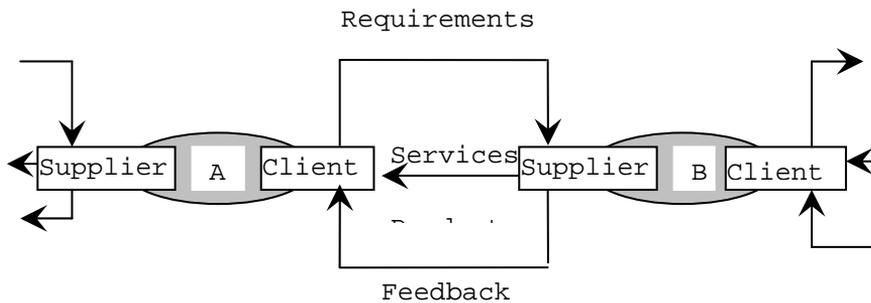
customer. The new concept of quality focuses on identifying quality problems at the source and correcting them.

### Management supplier quality

TQM extends the concept of quality to a company's suppliers. The philosophy of TQM extends the concept of quality to suppliers and ensures that they engage in the same quality practices. If suppliers meet preset quality standards, materials do not have to be inspected upon arrival. Today, many companies have a representative residing at their supplier's location, thereby involving the supplier in every stage from product design to final production.

In order to obtain certain relations reciprocally advantageous we must analyze the following steps :

- Establishing the fields in which reciprocally advantageous relations could be developed between the suppliers and the organization;
- Creating a list with the potential partners;
- Identifying the persons with decision powers within the suppliers organization ;
- Forming a team responsible for the development of new relations ;
- Developing the mission and objectives which underlie the partnership;



**Figure 6. – Internalizing the relation client - supplier (Source: Total Quality Management, Marieta Olaru - ASE Bucharest)**

The main benefits of applying this principle :

- Increased ability to create value for both parties
- Flexibility and speed of the common answer to the market changes or to the clients' needs and expectations modifications.
- The optimization of costs and resources

The application of this principle will lead to :

- The establishment of relations able to balance the short term profits with the long term considerations

- The use of the expertise and resources together with the partners
- The identification and selection of the key suppliers
- The establishment of a clear and open communication system
- The communication of information and future plans
- The establishment of common development actions and of certain improvement activities
- The suggestion, encouragement and recognition of suppliers' improvements and accomplishments.

## Conclusion

The principles of Total Quality Management are to seek to satisfy the external customer with quality goods and services, as well as your company internal customers; to satisfy your external and internal suppliers; and to continuously improve processes by working smarter and using special quality methods.

TQM encourages participation amongst shop floor workers and managers. There is no single theoretical formalization of total quality, but Deming, Juran and Ishikawa provide the core assumptions, as a "...discipline and philosophy of management which institutionalizes planned and continuous... improvement ... and assumes that quality is the outcome of all activities that take place within an organization; that all functions and all employees have to participate in the improvement process; that organizations need both quality systems and a quality culture."

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## COORDINATES OF BANKING SERVICES QUALITY MANAGEMENT

*Elisabeta Andreea Budacia, Nicolai Laurențiu Hreniuc, Alexandra Perju and Mihaela Moldovan\**

### **Abstract**

*In the field of services, quality is, in general, defined by the client and the management ensures the overfulfilment of the client's demands and expectations.*

*The quality of services implies two essential aspects that a manager has to take into account: the client's satisfaction and the absence of the errors made by employees. Introducing a system of quality management has the goal of satisfying the clients and surpassing their expectations. Such a system has to be dynamic, which makes it adaptable to the clients' needs, demands and expectations.*

*Principles of quality management in banking institutions have to be : customer orientation, leadership, personnel involvement, procedural approach, system approach to management, continuous improvement, factual approach to decision, mutually beneficial supplier relationships.*

**JEL Classification:** M12, M31, M54

In the field of services, quality is, in general, defined by the client and the management ensures the overfulfilment of the client's demands and expectations. The goal of quality management regarding services implies that the client's expectations are understood, concerning quality, and that a plan and a proactiv process are designed in order to achieve this goal.

The origin of quality objectives is revealed by the clients' needs; this is why the scientific basis of quality management has to be market-oriented. The strategic quality objectives have a major impact on the process of services accomplishment and of offer in general, ensuring the performances of the final service and of the processes which make it up.

The quality of services implies two essential aspects that a manager has to take into account: the client's satisfaction and the absence of the errors made by employees. As far as the clients are concerned, the higher the level of satisfaction and initial expectations achieved, the higher the quality of received / bought services. Moreover, the absence of the errors made by employees determines a higher quality of the respective offer. Introducing a system of quality management has the goal of

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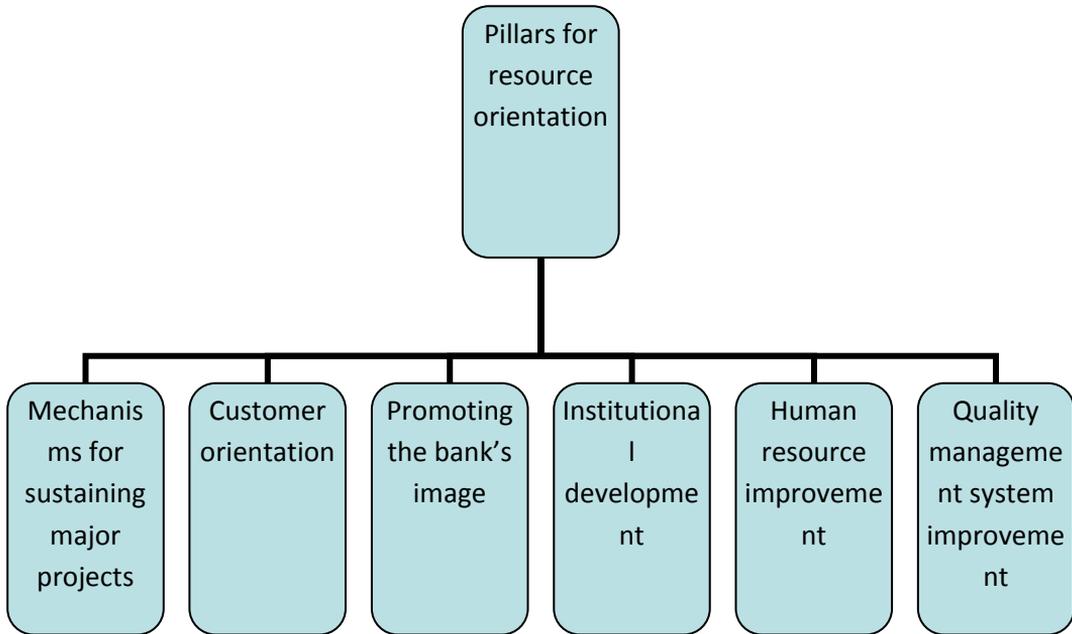
satisfying the clients and surpassing their expectations. Such a system has to be dynamic, which makes it adaptable to the clients' needs, demands and expectations. At the level of the enterprises, the quality depends on the activities developed on three hierarchical levels:

- ✓ top management, which established the quality strategy, the policy and the quality objectives on long term;
- ✓ the department (head of division) where are established the tactics and the measures of strategy enforcement through concrete activities;
- ✓ the accomplisners (team leaders) who act at an operational level and determine the accomplishment of the quality.

Banking quality policy must be consistent with the overall policy and strategy and is bank- and customer satisfaction oriented, it takes into account the expectations and needs of all stakeholders. To fulfill this mission, an approach to quality management standards is recommended, based on the SR EN ISO 9001:2008 standard. Bank's top management is committed to guiding all resources and ensuring the framework for all activities, taking into account the following:

- improve support mechanisms, given the financial crisis and global economic conditions, improving projects of national importance, in accordance with government policy and strategy;
- orientation towards meeting the current and future needs and expectations of customers;
- promote the image of the respective bank;
- institutional development of the bank by permanently adapting the organization to the requirements of a modern and dynamic banking and financial institution;
- improve the human resource component in accordance with the requirements of permanent innovation and change in the bank's activity;
- continuous improvement of the quality management system within the bank.

**Figure no. 1**  
**The Pillars on Which Top Management Must Focus Their Resources**



- *Improvement of support mechanisms, given the financial crisis and global economic conditions, improving projects of national importance, in accordance with government policy and strategy*

The bank, seen as a dynamic and active promoter of the Romanian business environment and international transactions, through financial - banking and specific assurance tools will guide the work to improve support mechanisms - in the financial crisis and global economic conditions – for Romanian exports and projects of national importance, to strengthen, in line with government policy and strategy, a competitive Romanian economy. The strategic priorities of this period are considering, on the one hand, the economic and financial context and development objectives of the Romanian Government, and the available sources on the other.

- *Orientation towards meeting the current and future needs and expectations of customers should particularly include the following:*

- SMEs, with high potential for accumulation and development, for projects that contribute to the rise of competitiveness and adaptation to EU standards;
- corporations for specific large projects.

Respecting the provisions of SR EN ISO 9001:2008, the activities of any bank will be based on the main principles of the quality management system, customer orientation and increasing their satisfaction and will be focused on:

- ~ Creating a climate of trust and mutual respect between customers and the bank, ensured by objective and civilized professional behaviour of all staff in their

interactions with the customer;

~ Ensuring equal treatment of customers, a goal according to which bank employees have a duty to apply the same legal and regulatory regime in the same or similar circumstances;

~ Insuring quality of service through active participation in tasks, decision making and implementation in practice for customer and partner benefit, in order to achieve an efficient overall activity;

~ Openness and transparency towards customers, a principle according to which the activities of bank employees in relation to their respective customers are monitored;

~ Shortening the duration of customer records analysis;

~ Fast and reliable services for the operations performed by clients;

~ Timely responses, flexible and relevant to customer requests.

Any bank should be concerned, at all times, to develop lasting relationships with customers, aiming to increase their satisfaction by:

~ Development of financial services and banking products and flexible tailor to anticipate market needs and customer requirements;

~ Identify opportunities for collaboration with the banking and financial institutions, business organizations and private organizations, to support exports, Romanian business environment development and support international transactions;

~ Ensuring operational efficiency through optimal operation of the IT system, the competence and efficiency of staff, both in the front office and back office;

~ Ongoing maintenance and improvement of the centralized bank customers database; ~ Continue to maintain a good communication with customers through staff at all the internal structures involved.

#### ● *Promoting the bank's image*

Strengthening the position and active factor role of the bank should be reflected in the business image and in the bank's communication strategy.

Particular attention should be paid to active promotion of products and services operators, local and central government, including their subordinate institutions and credit and insurance institutions.

To raise awareness of the role played by the products offered have and to conduct programs and projects of national and regional importance, a comprehensive program to promote all the specific products should be ensured, in order to increase their understanding and access by operators. In this respect, to improve communication, the following measures should be considered:

~ Analyzing and improving the flow of documents in the bank to reduce the decision process duration;

~ Increasing the volume of customer information sent through the site;

~ Improving the interactive operations of the site outside the bank to increase the fluidity and information circuit from and to customers, to reduce response time

on customer requests;

- ~ Enhance media cooperation for the bank;
- ~ Improving Internet Banking, to ensure the fast, safe and effective way of establishing operations for customers anywhere, and at any time.

● *Institutional development of the bank by permanently adapting the organization to the requirements of a modern and dynamic banking and financial institution*

Any banking institution must pay particular attention to innovative development of the institution both in terms of organization and infrastructure, while improving the regulatory framework governing its activities, risk management and adaptation to the requirements of specific national and EU legislation . Given current market conditions, special attention will be paid to credit risk.

Also , efforts will be made to develop and strengthen the regional network and to increase the activity of existing regional business units and implement concrete measures of involvement in specific marketing actions, promotion and collaboration with local bodies, to develop the regional business environment.

● *Improve the human resource component in accordance with the requirements of permanent innovation and change in the bank's activity*

The human resources policy must be based on fairness and equal opportunity for all employees, they are evaluated and rewarded based on competencies and achievement of individual/collective objectives

Recognizing that the organization's main resource is the staff, the management team is constantly concerned with training and motivation, as an essential tool for unlocking the full potential of the bank. In this sense, the opinion of Richard Dow, marketing specialist, is relevant: "The four Is of services are: individuals, individuals, individuals and individuals".

The professional training program must be designed and reoriented in order to correlate it with the needs identified, both at the banking system level and within the bank's internal structures.

It is also necessary that each organizational structure continues in the process of employee awareness on related topics:

- the quality management system
- the internal regulatory system
- general banking
- activities specific to each internal structure.

However, we should take into account the fact that the personnel does not have the same role in a banking institution. Its role is determined by the frequency with which it comes in contact with the client (permanently, periodically, occasionally, etc.). Therefore, the personnel can be classified into contact personnel, those who make modifications, those who influence and those who are isolated.

✕ The contact personnel represents that category of the staff that comes permanently in contact with the clients, being the accomplishment personnel, that makes the service or a main part of it. The contact personnel is an important

element of differentiation for similar services and its influence is reflected in the personalized services (technique of adapting the offer to the particular demands of each client).

*Table no. 1*

**The main competences and responsibilities of the contact personnel**

Competences	Responsibilities
× comercial competences	× selling the respective service
× technical competences	× accomplishing the service
× relational and communication competences	× efficiently administrating the service through gestures, verbal expressions, etc.
× institutional competences	× the identification with the respective enterprise

*Source:* Dupont, Frédéric, *Management des services*, Editions ESKA, Paris, 2000., p.57

× Those who make modifications are the category of personnel that comes periodically in contact with the client (secretaries, receptionists, etc.). They help the accomplishment of the service and that is why they have to be selected and trained so that they know the firm's strategies and participate in them.

× Those who influence have a special role in preparing the conditions for a good development of the service (leading and research personnel, etc.).

× Those who are isolated (indifferent) are the persons who don't come in contact with the client or they do, but by hazard. They ensure the support necessary for the development of the service in good conditions. The activity of this category is mirrored in the quality of the service accomplishment (persons from the supply department, etc.).

● *Continuous improvement of the quality management system within the bank*

The policy and quality objectives are aimed at continuous improvement of the quality management system and maintaining its certification. This can be achieved by:

- the continuous deepening of training, internal quality audits and analysis of all aspects of their implementation and enforcement of the provisions of quality standards and documentation requirements related to the quality management system;

- consultation with internal and external publications on the issue of quality management;

- attending seminars, conferences and symposiums on the topic of quality management;

- increasing training on the quality management system subject;

- training of internal quality auditors and participation in training courses organized by institutions authorized and certified and training of all newly hired employees in leading positions of internal structures, having the responsibility for process and quality, and employees designated responsible for quality within the individual internal structures;
- ensuring permanent correlation between the provisions of the normative documents and work procedures to those of the Quality Management Manual, general procedures and specific procedures related to the quality management system;
- continuous adaptation of the quality management system (QMS) and QMS documentation and organizational changes made to the bank so that the QMS forms a dynamic and flexible tool for institutional development.

In applying these principles to the business orientation and understanding the importance of focus on customer satisfaction and performance, the management of banking institutions should be actively involved and support the maintenance and continuous improvement of the quality management system in accordance with the requirements of SR EN ISO 9001:2008 . In accordance with this goal, a bank should work towards achieving the following objectives:

- ✓ Providing competitive products and services, broadening the customer base and achieving a minimum customer satisfaction index of 85% in each territorial unit, reducing response time to customers and differentiated customer approach of large companies, compared to SME type customers .
- ✓ Active involvement of all structures in achieving bank business development under the *Bank strategy* and *Sales plan*, while seeking increased efficiency and quality of work of each employee.
- ✓ Promote bank products under the marketing plan, increasing awareness and access to bank products by operators, by organizing events such as: *Customer Day*, quarterly workshops, promotion, target groups, messages regarding the bank's activity and the range of products it offers, through advertising campaigns, involving the appearance in the media and on the internet of commercials, articles and interviews
- ✓ Development of relations with the banking and financial institutions, business associations and business organizations to identify opportunities for supporting exports, the Romanian business environment and support international transactions, and conclude and annually implement agreements with financial and banking institutions.
- ✓ Increase the staff performance and involve at least 30% of bank staff in the annual training, including quality management training. Participation of employees involved in the sales, analysis and monitoring in at least two courses / training activities per year on topics specific to their activities.

✓ Improving cooperation between territorial units and structures in Central fluidity and efficiency for general activity, establishment of a functional reporting relationship between the divisions of branches corresponding and central departments, implementing an electronic feed to grant approval of products for SMEs.

✓ Improving the work environment and infrastructure by developing new banking software functionality and an efficient management of assets, upgrading the Internet Banking service offered to customers;

✓ Continuous improvement of the quality management system through continuous monitoring compliance with the provisions of relevant documentation of the quality management system according to SR EN ISO 9001:2008 requirements and ensuring its consistency with the provisions of the normative documents and work procedures and organizational changes drafting the new edition of the documentation of quality management.

In conclusion, for any banking institution to be managed and operate efficiently, its activities should be coordinated and monitored in a systematic way based on eight quality management principles, which we summarized in the following table:

**Table no. 1**  
**Principles of Quality Management in Banking Institutions**

<b>Principles of Quality Management in Banking Institutions</b>	<b>Details</b>
<b>Customer orientation</b>	Organizations depend on their customers and therefore should understand their current and future needs, should meet customer requirements and should strive to exceed their expectations
<b>Leadership</b>	Leaders establish unity of purpose and direction of the organization, and should establish and maintain the internal environment in which staff can become fully involved in achieving organizational objectives
<b>Personnel involvement</b>	Staff at all levels is the essence of an organization and involvement of all abilities allow it to be used to the organization's benefit.
<b>Procedural approach</b>	The desired result is achieved more efficiently when activities and related resources are managed as a process
<b>System approach to management</b>	Identifying, understanding and managing related processes as a system contributes to the efficiency of an organization in achieving its objectives.

<b>Continuous improvement</b>	Continuous improvement of overall performance of an organization should be a permanent objective
<b>Factual approach to decision</b>	Efficient decisions are based on data analysis and information.
<b>Mutually beneficial supplier relationships</b>	An organization and its suppliers / customers are interdependent and a mutually beneficial relationship increases the ability of both to create value.

The scientific basis of quality management of the banking services has to ensure the modalities necessary for obtaining the client's satisfaction. In this sense, organizations have to know the way in which the clients perceive the products and services' quality, the level of quality that the clients expect from the organization and the competition in the respective domain of activity. The following aspects have been revealed by research regarding the principles of client-oriented quality management:

- the quality has to be the same in all the banks' activities;
- the constant quality level cannot be achieved without the implication of all the organizations which contribute to the offering of the respective services;
- satisfying the clients/beneficiaries implies a permanent communication with the clients and with the logistic chain of services;
- the quality of services cannot be useful if it is not perceived by clients.

The quality of banking services is the result of comparing the clients' expectations with the experience that the client has during the service accomplishment. Therefore, quality is defined by clients, they appreciate the good, mediocre or bad quality. Other appreciations are irrelevant and insufficient. The starting point in perceiving the service quality is the way in which the service accomplisher fulfils the service in accordance with the client's expectations. Quality cannot be a goal in itself; it has to be based on the clients' desires and necessities. Moreover, these desires being subjective, it is difficult to determine the quality of services from an objective point of view.

The clients' exigencies are higher and higher and sophisticated, which implies financial efforts from service accomplishers in order to identify and achieve these exigencies. A firm has to always take into account the efforts made to improve the quality of a service and the financial effects of the usual result.

Each employee of a service company contributes in a certain degree at the positive or negative perception of quality. During the service development, a reduced number of persons can be involved, but their activity also depends on the rest of the employees who do not have a direct contact with the public and who are also responsible for the delivered quality. The entire personnel of the company contributes to the quality formation and if a certain employee does not fulfil his/her tasks appropriately, the respective service will be affected.

Ensuring a service of at least an acceptable quality is in all cases mandatory, but insufficient in the situation in which a banking company wants to excell in the

domain of services. Obtaining a very good quality should be the objective of every bank that wants a solid reputation and long-term relationships with its beneficiaries.

If the quality of a service is not appreciated appropriately by the company, the first issue is to determine the causes. An explanation would be the low level of the actual service accomplishment or a negative experience of the consumer during the activity of service delivery. So, situations can appear in which the commercial exaggerates the company's promises and a certain segment of consumers repond to that commercial, consumers that have higher expectations.

Because the banking institutions influence the expectations' level through their implicate and/or explicit promises, an important aspect concerning the achievement of a certain equilibrium between the bank's offer and the consumers' expectations is respecting the promises that were made. Companies have higher chances of success when the promises reflect the real quality of the service.

In the domain of services, where in the majority of cases there is no control of the quality before the accomplishment of a service, the client also experiments certain errors. As a result, managers have to identify the causes that can prevent the activity development in conditions of quality ensurance. The main errors that have to be avoided by the companies in the domain of services are the following: not identifying or wrongly identifying the consumers' needs, errors in the formulation of quality standards, errors in designing the service, inappropriate leading methods.

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## SMALL AND MEDIUM-SIZED ENTITIES BETWEEN THE ACCRUAL BASIS OF ACCOUNTING AND CASH ACCOUNTING

Mihai Ristea, Alexandra Doros, Corina Ioanăș and Dragos Dan Morega\*

### Abstract

*Should revenue be recognized when generated or when ultimately collected by a company? Should expenses be recognized when incurred or when finally paid? The answers to these questions vary and are dependent on whether an entity employs the cash or accrual basis of accounting. The cash basis of accounting focuses on the cash flows connected with revenue and expenses. But the cash basis of accounting is criticized as not being in accord with economic reality. The accrual basis of accounting overcomes the chief limitation of the cash basis – a possible mismatch of revenue and expenses.*

**Keywords:** Cash accounting, accrual basis of accounting, IFRS Project, financial statements, cash-flow

**JEL Classification:** M21, M41

### Introduction

At international level, IFRS has elaborated „*The IFRS Project for SMEs*”. One of the objectives of this project is to create a single set of accounting standards to stand at the base of the „production” and at the constant flow of high quality informations, clear and compatible in financial situations and in other financial reports created for SMEs. As shown in the standard, often SMEs create financial statements for the sole use of the proprietors – directors or for fiscal reporting or in other regulatory ways that don't relate to the value titles. In the IFRS spirit, these reports are circumscribed only to these purposes cannot be accepted as general purpose financial statements.

The adoption authority of „*The IFRS Project for SMEs*” belongs to the national settlement institutions and normalizers. As shown in „*The IFRS Project for SMEs*” it is conceived to be used by **small and medium-sized enterprises** (SMEs). SMEs are enterprises which:

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(a) do not have a **public responsibility**.

(b) publish **financial situations with general purpose** for external users. External users examples include proprietors which are not involved in conducting the activity, existing and potential creditors and as well the rating agencies.

An entity has a public responsibility if:

(a) it advanced or is about to advance **it's own financial statements** towards a value titles commity or to any other settlement organism for the purpose of emitting any class of instruments on a public market; or

(b) it owns assests in fiduciary quality for an external group, like a bank, an insurance company, a broker/dealer of value titles, a pension fund, a mutual fund of investments or a banking society of investments.

This standard [project] doesn't acknowledge normalising value if an entity which has public responsibility utilizes it for the making and presenting of financial statements, these won't be described as in conformity with the *IFRS for the SMEs* – even if the legislation or the national rulings allow that this standard [project] to be used by enterprises that have a public responsibility.

The project IFRS/SMEs is based in its esence on the accounting objectives, principles and treatments formalised in the “*IFRS Network*”. The esence elements regarding the recognition and evaluation, the options of accounting politics, the presentation and interpretation of the informations presented in the IFRS network are at home in the IFRS/SMEs, with some simplifications, of course.

Amongst the fundamentals of the „*IFRS Network*” assumed in the IFRS/SMEs Project the accrual basis of accounting can be found. “*An entity will constitut its financial statements, with the exception of the treasury information flux, utilising the accrual accounting. According to the accrual accounting, elements are acknowledged as assets, liabilities, own capitals, income and expenses (elements of financial statements) if they respect the definitions and the criterias of recognition for those elements*”.

*IFRS/SMEs Project* contains the following recognition rules:

(a) **an asset** is recognized in the balance sheet when probably future economical benefits will be generated towards the entity and the asset has a cost or a value that can be evaluated in a credible way. An asset is not recognized in the balance sheet when an expense was committed, an expense for which it's considered unlikely that benefits will be generated towards the entity outside of the curent accounting period. Instead, a transaction of this kind generates the recognition of other expenses in the profit and loss account.

(b) an entity recognizes **a debt** in the balance sheet when: 1.it is likely that the deduction of a present obligation might lead to an outflow of resources which incorporates economical benefits 2. and when the value level at which the settlement can be evaluated in a credible way.

(c) the recognition of the **income** results directly from the recognition of the assets and the liabilities. An entity will recognise the income in the profit and loss account when an increase of the future economical benefits was generated, benefits which are afferent to the growth of an asset or to the decrease of a debt - and this

growth can be evaluated in a credible way.

**(d)** the recognition of **expenses** it's also a direct result of the recognition and evaluation of assets and liabilities. An entity will recognise expenses in the profit and loss account when a decrease of the future economical benefits was generated, afferent to the decrease of an asset or to the increase of a debt - and this decrease can be evaluated in a credible way.

**(e)** profit or loss represents the arithmetical difference between income and expenses. It is not a separate element of the financial statements and it's not necessarily a distinct recognition principle of it.

**(f)** this [project] standard doesn't permit the recognition of the elements from the balance sheet which don't fulfil the definition of asset or debt, regardless if they are a result or not of the application of the notion, generically called, „the concept of correlation”.

Some elements regarding the area of applicability definitory for the *IFRS/SMEs Project*:

**(a)** *the area of applicability*, small and medium-sized entities as enterprises which:

**(a1)** don't have public responsibility and

**(a2)** publish general purpose financial situations for external users (proprietors which are not involved in conducting the activity, existing and potential creditors, as well as rating agencies);

**(b)** the concepts and general principles are the ones found in the IFRS Network (the objectives of financial statements, the qualitative characteristics of the information within the financial statements, elements recognition and evaluation in financial statements, etc.);

**(c)** the convention of accrual basis of accounting in element recognition, with the exception of the treasury flux when developing financial statements, and, mainly, the probability to produce economical benefits and credible evaluation;

**(d)** the formation and content of financial statements, mainly, the balance-sheet, the profit and loss account, the modification situation of own capitals, the situation of cash flows and notes (containing a summary of notable accounting policies and other important informations);

**(e)** individual financial statements that are consolidated in the case of the group formed by a **mother** entity and its **branches**; the consolidation methodology;

**(f)** accounting politics, estimates and errors; the selection, the applying and the modification of accounting policies;

**(g)** the accounting of financial assets and financial liabilities, risk coverage accounting; **(h)** considerations regarding their real value;

**(i)** stock accounting; investments in associated entities; investments in joint ventures; real-estate investments; corporal capitals; non-corporal capitals other than the commercial fund; enterprise combinations and commercial fund; leasing contracts; provisions and contingents; own capital; incomes; government subsidies; payments in stocks; depreciation of non-financial assets; employee benefits; taxation of profits; financial reporting in hyperinflationary economies; currency conversion; segment

reporting; events occurring after the end of the reporting period; disclosure of related parties; earnings per share; specialized industries (agriculture); discontinued operations and assets held for sale; interim financial reporting.

### Cash accounting for SMEs. Project proposal

The IFRS project as described in the above version, based on accrual accounting, offers a complete version of accounting, preparation, presentation, financial analysis and interpretation of financial statements. Although financial statements must be complete they also must respect the threshold of meaning and cost. In our view, given that there are a variety of structures on sites SMEs, bigger or smaller, with single or complex activities, the accounting, the preparation and presentation of financial statements are not included, in all cases, in the restriction of <<*the equilibrium between benefits and cost*>>.

The project we propose addresses especially small and medium-sized entities performing singular activities (e.g. production and sale of products) or with a low volume of transactions and events. The decision to choose between IFRS project, that we call *Accrual accounting*, and the project proposed by us, called the *Cash Accounting* belongs to the management of the entity.

Forcing the note in relation to the size of small and medium entities and their position on financial and goods markets, the solution of a simplified joint reporting can be accepted: *commitments - cash*. We are not excluding the option that certain categories of entities can produce only *tax reports*.

Cash accounting is based on cash flows defined by the relation of balance between receipts and payments. At the time for activity closure, based on the intermittent inventory for material goods, receivables, liabilities and own capitals instruments, the three financial statements are built, which we consider crucial for SMEs: *the balance sheet, the profit and loss account and the cash flow situation*.

The specific scheme for this type of accounting models is presented at pag 4-5.

Organizing the cash accounting system is based on the following categories of records:

a) *The accounting book – general log* for the chronological record of all documents;  
b) *The accounting book – log of proceeds and payments* in which are recorded chronologically, day by day, operations of proceeds and payments based on documents in proof. In our opinion to achieve this book-log, separate management of two logs is necessary, respectively, the *log earnings* and the *log payments*.

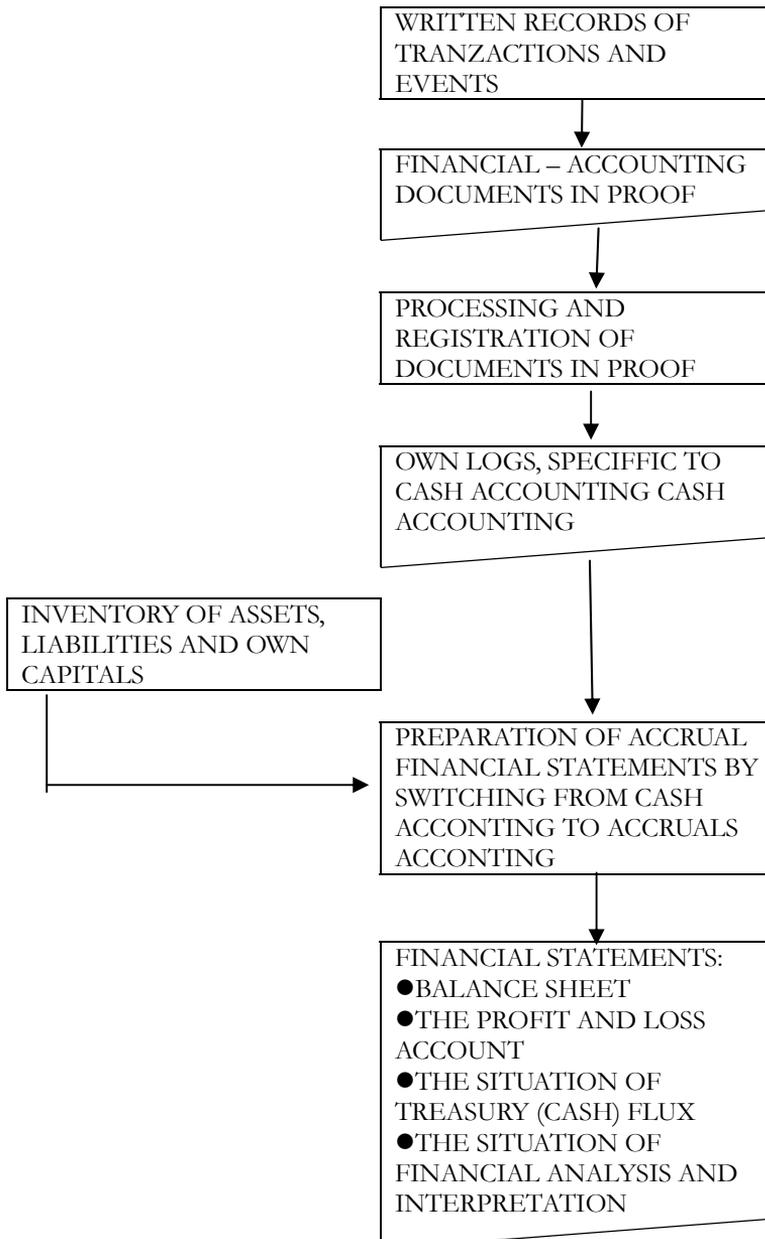
c) *the General selective ledger*, only in case of emergency, e.g. in the case of personnel expenses.

Recording transactions in cash accounts is based on double counting. The types of records differ on the nature of revenue/proceeds and expenses/payments. All records are be made in the two logs, in the *earnings* one, and, in the *payments* one.

Thus, the recording of the sales is accomplished through the relation:

xx €                      *Salaries*                      or = *The Register*                      xx €  
    *Proceeds*

Since in the flow of the Wages account the net paid salary is recorded, in a corresponding way te salary deductions should be reflected. To this end, a ledger is open for the Payroll in which all the componenets for salaries are registered. From the salary deductions the following formula is assembled:





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2.6.	Contributions of capital	XX
2.7.	Intrests	XX
<b>II. TOTAL OTHER PROCEEDS</b>		XX
<b>III. TOTAL PROCEEDS</b>		XX

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**PAYMENTS**

1.	EXPLOITATION PAYMENTS	
1.1.	Stock buyings	XX
1.2.	Salaries, insurances and social security	XX
1.3.	Taxes and fees	XX
1.4.	Services received from third parties	XX
	• Commissions	XX
	• Electric energy	XX
	• Thermal energy	XX
	• Post and communications	XX
	• Rents	XX
	• Maintenance and repairs	XX
	• Insurances	XX
	• Other services	XX
<b>IV. TOTAL EXPLOITATION PAYMENTS</b>		XX
2.	OTHER PAYMENTS	
2.1.	Purchasing of non current assets	XX
2.2.	Short-term bank loan reimbursments	XX
2.3.	Medium and long-term bank loan reimbursments	XX
2.4.	Results sampling	XX
2.5.	Intrests	XX
<b>V. TOTAL OTHER PAYMENTS</b>		XX
<b>VI. TOTAL PAYMENTS</b>		XX
3.	THE SURPLUS (THE DEFICIENCY) OF PROCEEDS OVER PAYMENTS	XX

According to the principle of practice independence, the criteria used to recognise the expenses and incomes by the result of practice, can only be that of engagement. Incomes are registered in the moment of their acquiry, and expenses while they get engaged. Accounting on such a base is encoded under the name **accrual basis of accounting**.

Interpreting incomes, according to the above criteria, makes the income independent of proceed and leads to to its registration prior to the moment of proceed. By correspondance, starting from the principle of expenses belonging to the incomes, meaning expenses represent a cost used for obtaining an income, implicitly expenses are dissociated from payments.

Still, at the base of interferences between real fluxes (incomes and expenses are associated to the movements of goods and services) and monetary fluxes (proceeds and payments), the accounting result can be calculated based on a **cash accounting**.

Starting with the *log of proceeds and payments* and with the *loges*, to which the of *assets and liabilities inventory* can be added, the *account of profit and loss* can be generated. The calculation relations are based on the balance that can be settled between incomes-expenses and proceeds-payments. For this purpose a balance of regularizations is made, as such:

SPECIFICATION OF THE EXPENSE-INCOME	PAYMENTS - PROCEEDS	BALANCE VARIATION LIABILITIES/ RECOVERABLE DEBTS	EGAGED EXPENSES/ INCOMES	OBSERVATIONS
0	1	2	3 = 1 ± 2	4

The recap of expenses and incomes in this situation is made according to the positions in the profit and loss account.

In relation to the nature of incomes and expenses, the transfer of proceeds in incomes and of payments in expenses is presented this way:

**a) sales incomes**

- registration in the proceeds log

$$\text{',Cash'} = \text{Sales}$$

or

Current accounts in banks

- determination of incomes from sales

- *Cashed in incomes*

- (+) *Final balance of recoverable debts towards the clients*
- (—) *Initial balance of recoverable debts towards the clients*
- (+) *The sums received in advance at the end of the period*
- (—) *The sums received in advance at the beginning of the period*

**(=) Incomes from sales**

In a similar way the other cashed incomes other than the ones from the sales, like onoraries, rents, intrusts etc.

**b) expenses regarding stored consumptions or sold stocks**

- registration in the payment log

$$\text{Stock buyings} = \text{',Cash'}$$

or

Current accounts in banks

■ determination of expenses regarding the stored consumptions or the sold consumptions

● *Payments regarding stocks buyings*

- ( + ) *Final balance of liabilities towards the suppliers, from stock buyings*
- ( - ) *Initial balance of liabilities towards the suppliers, from stock buyings*
- ( - ) *Sums paid in advance at the end of the period*
- ( + ) *Sums paid in advance at the beginning of the period*
- ( + ) *The initial stock of raw materials, materials and goods*
- ( - ) *The final stock of raw materials, materials and goods*

( = ) ***Expenses on raw materials, materials and goods***

c) **Expenses with works and services received from third parties**, the problem is resolved in a similar way to stocks buyings

d) **Expenses on taxes, fees and assimilated payments, personnel expenses și other payments generating expenses**, the evaluation is conducted on the base of the balancing relation:

Engaged	Paid	Final balance	Initial balance
=	+	-	

**Remark.** For salaries expenses it shall be added – reduced the variation of wages deduction, exclusively the advance that appears under ,cash' net payments.

e) **Expenses and incomes which do not generate fluxes of proceeds and payments**, like in the case of amortisations and provisions, they are evaluated on the base of inventory of assets and liabilities. In this regard it's stated that separate inventory lists will be made for the depreciated goods, unusable or deteriorated, not getting sold or unmarketable, abandoned or suspended current orders, also for recoverable debts and incert obligations or disputed. As regarding the amortization, it will be evaluated on the base of the *,tangible fixed assets chart'* which is going to be mandatory completed, according to the laws and norms of tangible fixed assets and intangible assets.

In order to calculate the result of commitments starting from the cash result (based on the relation between proceeds - payments ) the example below can be used:

● *The cash result*

- ( -, + ) *Increase/ decrease of own capitals and noncurrent liabilities*
- ( -, + ) *Increase/ decrease regarding fixed assets*
- ( -, + ) *Increase/ decrease of circulating assets and the increase/ decrease of current liabilities*
- ( -, + ) *The adjustments of non-cash elements (e.g. amortizations and provisions)*

( = ) ***The accruals accounting of Profit (Loss) before taxation***

The balance sheet of the financial position is built on the base of assets, liabilities and tools for own capitals inventory.

## Simplification regarding financial statements specific to cash accounting. Proposal

According to the global standard “*The IFRS/SMEs Project*”, financial statements created by small and medium-sized entities include:

- balance sheet (situation of the financial position)
- the profit and loss account (situation of the global result)
- situation of own capital modification
- situation of cash flow
- notes, containing a summary of meaningful accounting politics and other explanatory informations.

Accounting regulations according to the european directives, aproved by the *Order of the Minister of Finances n° 1752/2005*, pass the next set of financial statements for smal and medium-sized entities (which on the date for the balance sheet do not exceed the limits of two of the following criterias: total of assets is 3.650.000 euro; the net turnover is 7.300.000 euro; the average number of employees during the accounting period: 50):

- shortened balance sheet;
- profit and loss account;
- simplified explanatory notes to annual financial statements;
- optional, they can prepare the situation of own capital modification and/or the cash flows situation.

To simplify the set of financial statements we propose an option according to which a sole financial statement can be produced; we called this option ‘The situation of financial position and performance’. At the same time, an explanatory note to the financial statement’ shall be developed, that represents economic-financial indicators, specific and relevant. Such a proposed situation does not exclude developing and presenting cash flows, as well as explanatory notes regarding financial analysis and interpretation of informations.

The pattern of financial position and performance situation it’s presented as follows:

### The situation of financial position and perfomance - proposal -simplified-

<b>EXPENSES FROM ASSETS, CAPITALS AND LIABILITIES</b>	<b>INCOMES FROM ASSETS, CAPITALS AND LIABILITIES</b>
1.Assets to “N-1”	1.Own capitals to “N-1”
1.1. Fixed	1.1.Social capital
1.2. Circulating	1.2.Other own capitals
2. Expenses	2.Liabilities to “N-1”
2.1.Exploitation	2.1.Short term
2.2.Financials	2.2.Long term

3. Payments 3.1. Exploitation activity 3.2. Financing activity 3.3. Investment activity	3. Incomes 3.1. Exploitation 3.2. Financials
4. Own capitals to "N" 4.1. Social capital 4.2. Other own capitals	4. Cash-ins 4.1. Exploitation activity 4.2. Financing activity 4.3. Investment activity
5. Liabilities to "N"	5. Assets to "N"
<b>EXPENSES FROM ASSETS, CAPITALS AND LIABILITIES</b>	<b>INCOMES FROM ASSETS, CAPITALS AND LIABILITIES</b>
5.1. Short term 5.2. Long term	5.1. Fixed 5.2. Circulating
6. Result to "N" (+,-)	
7. Net cash to "N" (+,-)	
<b>TOTAL</b>	<b>TOTAL</b>

On the base of structures and elements from the financial statement economical-financial indicators can be calculated, specialised in the final financial position and in the financial performance of the entity. In a particular way, it presents the two resulting indicators: the net result of commitments and the net cash result, by appealing to the fundamental equations of accounting.

**(a) the general equation**

- *Assets to „N-1”*
- + *Expenses*
- + *Payments*
- + *Own capitals to „N”*
- + *Liabilities to „N”*
- ± *Resulted to „N”*
- ± *The net cash flow to „N”*
- = *TOTAL EXPENSES WITH ASSETS, OWN CAPITALS AND LIABILITIES TO „N”*
- *Own capitals to „N-1”*
- + *Liabilities to „N-1”*
- + *Incomes*
- + *Cash-ins*
- + *Assets to „N”*
- = *TOTAL INCOMES FROM ASSETS, OWN CAPITALS AND LIABILITIES TO „N”*

**(b) calculation result:**

● *Incomes*  
 - *Expenses*  
 = *Result*

or:

● *Own capitals to „N-1”*  
 + *Liabilities to „N-1”*  
 + *Cash ins*  
 + *Assets to „N”*  
 - *Assets to „N-1”*  
 - *Payments*  
 - *Own capitals to „N”*  
 - *Liabilities to „N”*  
 = *Result*

**(c) the calculation of the net cash flow:**

● *Cash ins*  
 - *Payments*  
 = *The net cash flow*

or:

● *Own capitals to „N-1”*  
 + *Liabilities to „N-1”*  
 + *Incomes*  
 + *Assets to „N”*  
 = *Total incomes*  
 - *Assets to „N-1”*  
 - *Expenses*  
 - *Own capitals to „N”*  
 - *Liabilities to „N”*  
 = *Net cash flow*

**Conclusion**

This article presented in the above chart in conceived on the base of economical criteria. Whithin it, the expenses of the period are grouped in relation to their nature, on phases of the economical circuit – supplying, production and sale. A distinctive position hasn't yet been created for the sale phase, because actual expenses structures executed in this phase represents, actually, represents a continuation of the production process in the sale area.

In designing of the overall situation, was also considered the necessity of its use to commensurate the obtained results by enterprises, expressed through the *value of the net production; the value of the sold goods production (the net turnover), the increase or decrease of circulating assets.*

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