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EDITORIAL

In this edition of the Journal of Economic and Social Development we present the best quality papers from the 9th International Scientific Conference on Economic and Social Development was held on 9 and 10 April 2015 in Istanbul, Turkey. From total of 58 papers, the best 8 papers are included in this edition.

The topics that are covered in this edition are: EU corporate governance, recent trends and developments, related to board composition and conflict of interests; Which SMEs perceive access to finance as an obstacle to their operations? Evidence from Turkey; How to integrate entrepreneurship education and creativity into a bureaucratic environment; The future of social policy in Europe: an analysis of atitudes toward social welfare; When Abdul meets David – developing a responsive regulatory system for islamic financial institutions: a case study of Australia; Relationship between market structure and stability in the banking industry; The interdependence of GDP per capita and foreign direct investment in the transitional economies of central and eastern Europe; Sustainability reporting: possible ways of rethninking hospitality accounting.

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Co-editor

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EU CORPORATE GOVERNANCE, RECENT TRENDS AND DEVELOPMENTS, RELATED TO BOARD COMPOSITION AND CONFLICT OF INTERESTS

Abstract

A modern and efficient corporate governance framework for European undertakings, investors and employees must be adapted to the needs of today's society and to the changing economic environment. High performing, effective boards are needed to challenge executive management. This means that boards need independent non-executive members with diverse views, skills and appropriate professional experience. Such members must also be willing to invest sufficient time in the work of the board.

The article addresses the following subjects which are at the heart of good corporate governance:

Comply or explain approach: The 'comply or explain' principle is an important tool for the application of the corporate governance rules in the EU. Most corporate governance is soft law and guidelines are included in voluntary national codes of conduct. In principle, member countries decide upon what type of legal instrument to use, in the respective field: mandatory or 'comply or explain'.

Board of directors, structure and composition: There is no uniform approach as regard structure of corporate governance. As generally known, there are two basic concepts of the public limited (joint stock) companies' corporate governance structures: one and two tier system. In EU, different board structures coexist. Depending on the country, listed companies may put in place either a 'single board' system (also called 'monistic' or 'unitary board' system), a two-tier (or 'dual board') system or some form of mixed system.

Non-executive or supervisory directors: The administrative, managerial and supervisory bodies should include an appropriate balance of executive (managing) and non-executive (supervisory) directors such that no individual or small group of individuals can dominate decision-making on the part of these bodies. A sufficient number of independent non-executive or supervisory directors should be elected to the (supervisory) board of companies to ensure that any material conflict of interest involving directors will be properly dealt with.

Independent directors: A director should be considered to be independent only if he is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement. duties is assured (Annex II, which identifies a number of situations reflecting the relationships or circumstances usually recognised as likely to generate material conflict of interest).Boards should be organised in such a way that a sufficient number of independent non-executive or supervisory directors play an effective role in key areas where the potential for conflict of interest is particularly high.

Board committees: Nomination, remuneration and audit committees should be created. The nomination, remuneration and audit committees should make recommendations aimed at preparing the decisions to be taken by the (supervisory) board itself. The primary purpose of the committees should be to increase the efficiency of the (supervisory) board by making sure that decisions are based on due consideration, and to help organise its work with a view to ensuring that the decisions it takes are free of material conflicts of interest.

Keywords

Non-executive or supervisory director, Board committees, Independent directors, Qualifications and commitment of directors, Evaluation, transparency and communication of the (supervisory) board

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1. Introduction

The 'Europe 2020' Communication[2] calls for improvement of the business environment in Europe. An effective corporate governance framework is of key **importance to society**, as well-run companies are likely to be **more competitive and more sustainable** in the long term (**2102** COMMUNICATION Action Plan: European company law).

Corporate governance and company law are essential to ensure that companies are well-governed and sustainable in the long term and therefore have an important role to play in the long-term financing of the economy[3].

Good corporate governance is first and foremost the responsibility of the company concerned. Rules at European and national level are in place to ensure that certain standards are respected. These include legislation and soft law, namely national corporate governance codes[4].

EU Company law is lagging behind the developments in the EU and world economy. In any discussion on the future of EU company law, the financial and economic crisis that has challenged the business environment over the last years must be taken into account. It is obvious that weaknesses and malfunctions in EU company law have attributed to the crisis.

The last comprehensive analysis of European Company Law **is** the Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union and the subsequent consultation on future priorities for this Action Plan carried out in 2005 and 2006 (**2102** COMMUNICATION Action Plan: European company law).

In particular rules on corporate governance statements have been introduced in the Accounting Directive (Directive 78/660/EEC), a Directive on the exercise of shareholders' rights Directive (2007/36/EC) and the Tenth Company Law Directive on Cross border mergers Directive (2005/56/EC) have been adopted.

Moreover, the Commission adopted two Recommendations regarding the role of independent non-executive directors and remuneration (Commission Recommendations 2005/162/EC and 2004/913/EC).

Besides, the Second Company Law Directive on formation of public limited liability companies and the maintenance and alteration of their capital8 and the Third and Sixth Company Law Directive on mergers and divisions have been simplified (Directives2007/63/EC and 2009/109/EC amending Directives 78/855/EEC and 82/891/EEC).

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[2] Communication from the Commission Europe 2020. A strategy for smart, sustainable and inclusive growth, COM(2010) 2020 final, p. 16-17.

[3] See also: OECD Principles of Corporate Governance, 2004, p. 11, accessible at http://www.oecd.org/dataoecd/32/18/31557724.pdf.

[4] 2014/208/EU: Commission Recommendation of 9 April 2014 on the quality of corporate governance reporting ('comply or explain') Text with EEA relevance (2014/208/EU)

A number of legal solutions concerning the functioning of financial markets including those regulating the issues of directors' disqualification and of the conflicts of interest arising between shareholders and managers, and those between shareholders and creditors, turned out to be weak, and therefore inappropriate and obsolete.

Harmonization can provide common rules and standards or it can remove obstacles. The choice of legal instrument ranges from directly binding regulations to directives requiring national implementation (Commission, 2011b).

Mere recommendations are not sufficient any more in fields like conflict of interest and directors' disqualification. Frankly speaking, there are some binding regulations (directives), which have been implemented into national legislations, especially in the field of financial market regulation, but this does not correspond with the emerging needs, caused by the circumstances of the crisis and nor does it aim to overcome them.[5]

Harmonization in the field of **conflict of interest and directors' boards composition** would make cross-border business operations in the EU market more transparent and contribute to sufficient safeguards against abuse, and prevent people engaged in abuse in one member state from continuing to carry on their abuse in another member state.

2. Comply or explain' approach

2.1. Comply or explain approach

The 'comply or explain' principle is an important tool for the application of the corporate governance rules in the EU. Most corporate governance is soft law and guidelines are included in voluntary national codes of conduct. In principle, member countries decide upon what type of legal instrument to use, in the respective field: mandatory or 'comply or explain'.

The "comply or explain" approach allows listed companies to depart from a particular recommendation of the applicable national corporate governance code, provided that they explain the reasons for doing so. In this way, it offers companies an important degree of flexibility to adapt their corporate governance to their specific situation, yet encourages them to follow corporate governance best practices.

[5] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse); Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC; Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC; Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids and Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies.

Also corporate governance codes in the EU are applied on a ‘comply or explain’ basis. This approach allows companies to depart from particular recommendations of the applicable code, provided they explain the reasons for doing so.

2.2. Mandatory corporate governance reporting

EU directive (Directive 2013/34/EU on the annual financial statements) requires companies to include a corporate governance statement in their management report if their transferable securities are admitted to trading on a regulated market of any Member State (see also Directive 2004/39 on markets in financial instruments);

According to the ‘comply or explain’ principle (Article 20 of Directive 2013/34/EU) companies that depart from the relevant corporate governance code are required to explain in their corporate governance statement which parts of the code they depart from and the reasons for doing so.

2.3. Shortcomings in the way of the ‘comply or explain’

In many Member States there is insufficient monitoring of the application of the codes. The informative quality of explanations published by companies departing from the corporate governance code’s recommendation is - in the majority of the cases - not satisfactory. The quality of the corporate governance reports produced by listed companies has been subject to criticism. The explanations provided by companies are often insufficient. They either simply state that they had departed from a recommendation without any further explanation, or provide only a general or limited explanation (Study on Monitoring).

There are shortcomings in the way the ‘comply or explain’ principle is applied. Companies often do not provide appropriate explanations when they depart from corporate governance codes. There is too much of flexibility in the implementation of the ‘comply or explain’ approach. This makes it more difficult for investors to take informed investment decisions; they are in favour of better quality explanations (2011 Green Paper)

2.4. Directive, rather than recommendations

Companies should provide better explanations for departing from codes’ recommendations. In some Member States discussions have been initiated or guidelines issued on the quality of explanations (2102 COMMUNICATION Action Plan: European company law).

However in order to maintain the key role of codes of conduct in ensuring good corporate governance and their legitimacy, more decisive action at EU level is needed. However the existing recommendation (2014 Recommendation on ‘comply or explain’ reporting) is not sufficient in order to implement EU guidance, across the EU. A directive, based on national best practices, legally binding for listed companies, investors and national monitoring bodies would be needed to improve the quality of disclosures and ensure better transparency.

National binding rules for companies, following the directive, should provide guidance on how they followed the relevant corporate governance codes on the topics of most importance for shareholders, in order to improve transparency and quality of corporate governance reporting and on how listed companies should explain their departures from the recommendations of the relevant corporate governance codes.

To what extent and how apply the ‘comply or explain’ approach (governance code recommendations) as opposed to compulsory regulation should depend on the corporate governance tradition and the level of business ethic in a respective country. Universal patterns and recipes for each country, regardless its corporate history and tradition, is wrong approach.

3. Board of directors

3.1. No uniform approach as regard structure of corporate governance

As generally known, there are two basic concepts of the public limited (joint stock) companies' corporate governance structures: one and two tier system. As concerns the legal regulation of the governance structures there is the approach of compulsory one tier system (like USA, UK and the followers) or compulsory two tier system (Germany, Austria and the followers).In addition, there are countries which leave shareholders to decide upon introduction on one or two tier system, according to Articles of Incorporation as France, Finland or for example Slovenia. There are also countries with different types of two tier system, with different competences and legal position of the Supervisory body, which range from more or less classical supervisory board, to supervisory or other monitoring and auditing bodies with limited competences. In addition there are legislations, with conditional and/or limited one or two tier system of corporate governance.

On a unitary board, one way to ensure this is that the roles of chairman and chief executive are separate; in the case of unitary and dual boards, one option may be that the chief executive does not immediately become the chairman of the (supervisory) board.

In EU, different board structures coexist. Depending on the country, listed companies may put in place either a ‘single board’ system (also called ‘monistic’ or ‘unitary board’ system), a two-tier (or ‘dual board’) system or some form of mixed system. These board structures are often deeply rooted in the country’s overall economic governance system.

3.2. Other stakeholders’ participation

It is important to underline that different governance systems have very little to do with the participation of other but capital stakeholders in in governance and appropriation in the profit of a corporation. All the different systems of corporate governance follow the same concept, the concept of one share one vote. The differences are not related to diversified stakeholders' participation in governing and supervising bodies (like labour) but rather to different organization of managerial and supervisory functions.

Yet there are systems, that permit more influence to employee representatives in management or supervisory board, however that should be considered as mere correction of dominant capital based corporate governance rather than corporate governance reform in the terms of changing the relationship between labour and capital.

3.3. Board composition

The composition of the board has to suit the company's business. Non-executive board members should be selected on the basis of a broad set of criteria, i.e. merit, professional qualifications, experience, the personal qualities of the candidate, independence and diversity (professional, international and gender). Diversity in the members' profiles and backgrounds gives the board a range of values, views and sets of competencies. It can lead to a wider pool of resources and expertise. Different leadership experiences, national or regional backgrounds or gender can provide effective means to tackle 'group-think' and generate new ideas. More diversity leads to more discussion, more monitoring and more challenges in the boardroom (2011 Green paper).

Diversity of competences and views among the board's members is very important. It facilitates understanding of the business organization and affairs and thus enables the board to challenge the management's decisions objectively and constructively. In contrast, insufficient diversity could lead to a so-called group-think process, translating into less debate, fewer ideas and challenges in the boardroom and potentially less effective oversight of the management board or executive directors. Increased transparency as regards board diversity policy (including gender balance among non-executive directors) could make companies reflect more on the issue (2011 GREEN PAPER Anex 2).

In order to encourage companies to enhance board diversity and give greater consideration to non-financial risks, disclosure requirements with regard to their board diversity policy was strengthened through amendment of the accounting Directive.

4. Conflicts of interest

4.1. Independent directors on the board

Independent representatives on the board, capable of challenging the decisions of management, is widely considered as a means of protecting the interests of shareholders and other stakeholders. In companies with a dispersed ownership, the primary concern is how to make managers accountable to weak shareholders. In companies with controlling shareholders, the focus is more on how to make sure that the company will be run in a way that sufficiently takes into account the interests of minority shareholders. Ensuring adequate protection for third parties is relevant in both cases (2003 Action Plan 'Modernising Company Law).

A sufficient number of independent non-executive or supervisory directors should be elected to the (supervisory) board of companies to ensure that any material conflict of interest involving directors will be properly dealt with.

4.2. Profile of independent non-executive or supervisory directors (for listed companies)

A director should be considered to be independent only if he is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement. duties is assured, which identifies a number of situations reflecting the relationships or circumstances usually recognised as likely to generate material conflict of interest).

There is no definition and legal regulation of "independence" in the context of directors, in any of the laws analysed. The independency of directors is not a legal obligation to be taken into consideration for the composition of corporate boards.

On the other hand, there are explanations in different codes and EU recommendations on this. However, the respective recommendation leaves it to the member countries to decide whether to implement the recommendation in the company legislation or to use the principle to explain or comply with the corporate governance codes. Unfortunately, the great majority of EU member countries decided for the latter, the consequence of which is poor implementation of legal remedies for solving conflicts of interest in European corporate legislation.

4.3. Criteria for independency

Criteria for independency, which should be, for listed companies, tailored to the national context, should be based on due consideration of at least the following situations (Anex II to Recommendation 2005/162 on the role of non-executive or supervisory directors):

(a) not to be an executive or managing director of the company or an associated company, and not having been in such a position for the previous five years;

(b) not to be an employee of the company or an associated company, and not having been in such a position for the previous three years, except when the non-executive or supervisory director does not belong to senior management and has been elected to the (supervisory) board in the context of a system of workers' representation recognised by law and providing for adequate protection against abusive dismissal and other forms of unfair treatment;

(c) not to receive, or have received, significant additional remuneration from the company or an associated company apart from a fee received as non-executive or supervisory director. Such additional remuneration covers in particular any participation in a share option or any other performance-related pay scheme; it does not cover the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the company (provided that such compensation is not contingent in any way on continued service);

(d) not to be or to represent in any way the controlling shareholder(s) (control being determined by reference to the cases mentioned in Article 1(1) of Council Directive 83/349/EEC (1));

(e) not to have, or have had within the last year, a significant business relationship with the company or an associated company, either directly or as a partner, shareholder, director or senior employee of a body having such a relationship. Business relationships include the situation of a significant supplier of goods or services (including financial, legal, advisory or consulting services), of a significant customer, and of organisations that receive significant contributions from the company or its group;

(f) not to be, or have been within the last three years, partner or employee of the present or former external auditor of the company or an associated company;

(g) not to be executive or managing director in another company in which an executive or managing director of the company is non-executive or supervisory director, and not to have other significant links with executive directors of the company through involvement in other companies or bodies;

(h) not to have served on the (supervisory) board as a non-executive or supervisory director for more than three terms (or, alternatively, more than 12 years where national law provides for normal terms of a very small length);

(i) not to be a close family member of an executive or managing director, or of persons in the situations referred to in points (a) to (h);

4.4. Requirements for disclosure

In the majority of the EU countries, directors must make full disclosure of all the relevant facts referring to the contract concluded on his own behalf in the field of companies business activities. However, only in some legislation is it a legally binding provision rather than a recommendation of the code. Declaring interest in an existing transaction or an arrangement under UK Law requires a director to declare any interest (direct or indirect) that he or she has in any transaction or arrangement entered into by the company.

There are four types of transaction requiring the approval of members in the Companies Act 2006: long-term service contracts, substantial property transactions, loans, quasi-loans and credit transactions and payments for the loss of office.

According to French law, the annual report gives details of the total remuneration and benefits of all kinds paid to each executive during the financial year from the company and controlled companies. The annual report also includes a list of all the posts and functions that each of those executives occupied in any company during the financial year. Contracts in which French directors are interested must be approved by the board, notified to the auditors and submitted to the general meeting .

According to the Slovenian Code, all legal transactions between the company and a member of the management board, as well as transactions between the company and persons or companies related to the member in whom he is personally involved are recommended (rather than legally defined as mandatory) to be concluded by observing the code of good practices and be publicly disclosed.

4.5. Non-executive or supervisory directors

Effective oversight of the executive directors or the management board by the non-executive directors or supervisory boards leads to successful governance of the company. Boards need non-executive (or supervisory board) members with diverse views, skills and appropriate professional experience. Board members must also be willing to invest sufficient time in the work of the board. (2011 GREEN PAPER Anex 2).

The administrative, managerial and supervisory bodies should include in total an appropriate balance of executive/ managing and non-executive/supervisory directors such that no individual or small group of individuals can dominate decision-making on the part of these bodies. On a unitary board, one way to ensure this is that the roles of chairman and chief executive are separate; in the case of unitary and dual boards, one option may be that the chief executive does not immediately become the chairman of the (supervisory) board. (Recommendation 2005/162 on the role of non-executive or supervisory directors).

The EU position (Recommendation 2005/162 on the role of non-executive or supervisory directors) as to the role of non-executive or supervisory directors is, that in key areas where executive directors clearly have conflicts of interest (i.e. remuneration of directors, and supervision of the audit of the company's accounts), decisions in listed companies should be made exclusively by non-executive or supervisory directors who are in the majority independent.

Non-executive or supervisory directors are recruited by companies for a variety of purposes. Of particular importance is their role in overseeing executive or managing directors and dealing with situations involving conflicts of interests.

Boards should be organised in such a way that a sufficient number of independent non-executive or supervisory directors play an effective role in key areas where the potential for conflict of interest is particularly high.

4.6. Role of the committee's vis-à-vis the (supervisory) board

The nomination, remuneration and audit committees should make recommendations aimed at preparing the decisions to be taken by the (supervisory) board itself. The primary purpose of the committees should be to increase the efficiency of the (supervisory) board by making sure that decisions are based on due consideration, and to help organise its work with a view to ensuring that the decisions it takes are free of material conflicts of interest.

4.7. Qualifications and commitment

The (supervisory) board should ensure that it is composed of members who, as a whole, have the required diversity of knowledge, judgement and experience to complete their tasks properly. The members of the audit committee, should, collectively, have a recent and relevant background in and experience of finance and accounting for listed companies appropriate to the company's activities.

Each director should devote to his duties the necessary time and attention, and should undertake to limit the number of his other professional commitments (in particular any directorships held in other companies) to such an extent that the proper performance of his duties is assured.

5. Some conclusions

The company laws in EU member countries in the field of structure and composition of the board of directors' and conflicts of interest and is not harmonized; there are separate and very diverse national pieces of legislation in this regard. Rules on diversity in composition and on independent directors and also on conflicts of interest at the EU level are mainly recommendations, rather than binding legal rules, which leave it to the member countries to decide either to implement the recommended concepts by legislation or merely in corporate governance codes (comply and explain).

Unfortunately, the voluntary principle "explain or comply" in corporate governance codes has been widely applied, as opposed to legislative implementation in EU member countries, which appears not to be the most appropriate and effective method of regulation, especially not in the times of world economic and financial crisis.

There are substantial and important differences in the legal regulation of board's members' position and conflicts of directors' interests between the EU countries. Bearing in mind that the world economic and financial crisis was to an important extent caused by inefficient corporate governance regulation, especially in financial services, a substantial harmonization of the EU regulation in the field of board director's diversity and independence, directors' disqualification and conflict of interest would be welcome.

The financial crisis has highlighted how important it is for legislators to react to the changing business environment and to react in due time with efficient legal tools. Further harmonization of company law, not in general but in particular fields of company law (like board director's diversity and independence, directors' disqualification and conflict of interest) is more than needed. Due to the financial roots of the economic crisis, this is especially true for financial service companies and listed companies, dealing with a broader public in a very sensitive financial field.

6. Literature

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3. COM(2012) 740/2 COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies (2102 COMMUNICATION Action Plan: European company law);
4. Commission Recommendation of 9 April 2014 on the quality of corporate governance) Text with EEA relevance (2014/208/EU) (2014 Recommendation on 'comply or explain' reporting);
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Aysa Ipek Erdogan[1]

WHICH SMES PERCEIVE ACCESS TO FINANCE AS AN OBSTACLE TO THEIR OPERATIONS? EVIDENCE FROM TURKEY

Abstract

Small and medium-sized enterprises (SMEs) have a fundamental role in the economic growth and job creation in almost all economies in the world. Access to finance is fundamental for the survival and growth of SMEs. However, financial constraints are considered to be one of the most important factors that impede the growth of these firms. To contribute to the understanding of the financial constraints faced by SMEs, this paper sets out to find the firm level determinants of perception of access to finance as an obstacle to the operations of Turkish SMEs. We find that size, age, percentage of sales exported and business group affiliation do not have an effect on the tendency to see access to finance as an obstacle. Audited firms are less inclined to see access to finance as an obstacle to their operations. This inclination decreases with an increase in the percentage of sales exported. Firms that have made a recent credit application have a lower tendency to see access to finance as an obstacle. This tendency is strengthened with an increase in the percentage of sales exported.

Keywords

Bank loans, Financial Constraints, SMEs

1. Introduction

SMEs are a central part of the economic fabric in almost all economies in the world. A thriving SME sector contributes to economic growth, entrepreneurial activity, job creation and innovation. Access to finance is fundamental for SMEs to grow and prosper. However, barriers to bank finance are ranked as one of most important constraints faced by SMEs (Hughes, 2009; Mason and Kwok, 2010; Shen, Shen, Xu and Bai, 2009). SME literature suggests that these firms face higher barriers to bank financing than large firms (Beck, Demirguc-Kunt, Laeven and Maksimovic, 2006; Beck, Demirguc-Kunt and Maksimovic, 2008; Pissarides, 1999). SMEs encounter greater difficulties in accessing bank financing because they are informationally opaque and it is difficult for banks to evaluate their corporate capabilities (Ang 1992; Berger and Udell, 1998; Gregory, Rutherford, Oswald and Gardiner, 2005).

Emerging market SMEs encounter more challenges in accessing bank financing (Hanedar, Broccardo and Bazzana, 2014; Menkhoff, Neuberger and Rungruxsirivorn, 2012; Menkhoff, Neuberger and Suwanaporn, 2006). The additional challenges are related to the preference of firms to operate outside the formal system. (OECD, 2006).

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Diamond (1991) suggests that because young and small firms do not have a long term relationships with banks so that they can establish reputational capital, the probability that they can receive credit is lower. Levenson and Willard (2000) contend that banks do not prefer to lend to smaller firms because the high fixed costs of granting loans to them lower profit margins. The authors find that smaller and younger firms have lower success rates in their loan applications. Chakravarty and Yılmazer (2009) also show that size of a firm has a positive relationship with the probability of being approved for a loan.

To contribute to the SME financing literature on emerging markets, this paper analyzes the firm level determinants of perception of access to finance as an obstacle to the operations of Turkish SMEs. The analysis uses the cross-sectional data set of 1,139 SMEs for the year 2013. We find that size, age, percentage of sales exported and business group affiliation do not affect the inclination to see access to finance as an obstacle. SMEs whose annual financial statements are checked and certified by external auditors have a lower inclination to see access to finance as an obstacle to their operations. However, this inclination decreases with an increase in the export intensity of the firms. We also find that SMEs that made a credit application in the last fiscal year have a lower tendency to perceive access to finance as an obstacle. This tendency is strengthened with an increase in the percentage of sales exported.

The remainder of the study is organized as follows: Section 2 discusses the research methodology. Section 3 depicts the sample and presents the summary statistics. Section 4 gives the results of the empirical study and section 5 concludes.

2. Research methodology

The perception of access to finance as an obstacle to the operations can be described with the following multiple regression model:

$$\text{Obstacle}_i = \beta_0 + \beta_1\text{Size} + \beta_2\text{Age} + \beta_3\text{Export} + \beta_4\text{Growth} + \beta_5\text{Group} + \beta_6\text{Audit} + \beta_7\text{Experience} + \varepsilon_i \quad (1)$$

Obstacle represents the dependent variable. We form our dependent variable from responses to the subsequent question: “To what degree is access to finance an obstacle to the current operations of this establishment?”. The responses vary between 1 (no obstacle), 2 (minor obstacle), 3 (moderate obstacle), 4 (major obstacle) and 5 (very severe obstacle). *Size* represents firm size which is proxied by the number of full time employees. *Age* stands for firm age. Age and size are expected to have a negative relationship with the perceived degree of accessibility of finance as an obstacle to the operations because younger and smaller firms may not have adequate reputational capital to have easy access to financing.

Export represents percentage of sales exported by the firm. Access to finance is expected to be positively affected by exposure to foreign trade. Competitive pressure exerted on exporting firms may positively affect access to finance through its effect on efficiency and quality of output (Ganesh-Kumar, Sen and Vaidya, 2001).

Growth stands for firm growth. Firm growth also may also affect perception of accessibility of finance as an obstacle to the operations. Firms with high growth may not perceive accessibility of finance as an obstacle because of their increasing cash flows. However, the requirement of a large amount of funds as a result of growth may make firms think that not having adequate access to finance adversely affect the operations (Canton, Grilo, Monteagudo, and Van der Zwan, 2010). We measure firm growth with the change in sales revenue in the last three years.

Group stands for the dummy variable for business-group affiliation. Perception of accessibility of finance as an obstacle may be influenced by group affiliation because group affiliated firms may use internal capital markets within groups as a source of finance.

Audit represents the dummy variable for whether the firm has its annual financial statements checked and certified by external auditors. We expect that firms that have audited financial statements are expected to encounter lower financing constraints and have better perceptions about the accessibility of finance as an obstacle the operations.

Experience represents the dummy variable for having a recent loan application experience. The variable is formed from the responses to the following question: "Did this establishment apply for any loans or lines of credit in 2012?". Recent experiences on bank loan applications may affect perception of accessibility of finance as an obstacle (Canton et al., 2010).

We also repeat the regression analysis by adding interaction terms between the audit and experience dummy variables and the export variable. Exposure to foreign trade is expected to affect the strength of the relationship between the given independent variables and the perception of access to finance as an obstacle to the operations. Our regression model with interaction effects is as follows:

$$\text{Obstacle}_i = \beta_0 + \beta_1\text{Size} + \beta_2\text{Age} + \beta_3\text{Export} + \beta_4\text{Growth} + \beta_5\text{Group} + \beta_6\text{Audit} + \beta_7\text{Audit} \times \text{Export} + \beta_8\text{Experience} + \beta_9\text{Experience} \times \text{Export} + \varepsilon_i \quad (2)$$

Multicollinearity is not a problem in our model because the VIF values of the independent variables are below the cutoff value of 4. Description of the variables used in the regression model is presented in Table 1.

Dependent Variable	
Obstacle	On a scale from 1 (no obstacle) to 5 (very severe obstacle), respondent gives an answer to the following question: ''To what degree is access to finance an obstacle to the current operations of this establishment?''.
Independent Variables	
Size	Number of full time employees
Age	Firm age
Export	Percentage of sales that was exported in 2012
Growth	Percentage change in sales revenue in the last three years
Group	Dummy=1 if the firm is part of a larger firm

Audit	Dummy=1 if the firm has its annual financial statements checked and certified by an external auditor
Experience	Dummy=1 if the firm applied for any loans or lines of credit in 2012

Table1: Description of the variables used in the regression model

3. Data

The cross-sectional data set comes from World Bank Enterprise Survey which was carried out in year 2013. 1,139 firms whose number of employees is less than or equal to 250 make up our sample. Firms in the sample operate in nine industry categories (food, textiles, garments, non-metallic mineral products, fabricated metal products, other manufacturing, retail and other services). For further information about World Bank Enterprise Surveys, you can visit the web site www.enterprisesurveys.org.

Table 2 gives the summary statistics of the variables.

	Mean	Standard Deviation	Median
Dependent Variable			
Obstacle	0.714	1.095	0
Independent Variables			
Size	43.667	51.637	21
Age	16.547	12.542	14
Export	28.685	38.219	0
Growth	0.385	0.514	0.273
Group (Dummy)	Percentage Frequency of 1= 85%		
Audit (Dummy)	Percentage Frequency of 1=48%		
Experience (Dummy)	Percentage Frequency of 1=60%		

Table 2: Summary statistics

We see that obstacle variable has a mean of 0.714. This shows that firms on average indicate that access to finance is roughly a minor obstacle to the current operations of the establishment. The mean age of firms is 16.54 years. Average percentage of sales that is exported by the sample firms is approximately 29%. Total sales revenue of firms grew by 38.5% on average in the last three years. 85% of the firms are part of a larger firm. 48% of the firms have their annual financial statements checked and certified by external auditors. 60% of the establishments applied for a loan or a line of credit in year 2012.

4. Empirical findings

The estimation results of the regression models are given in Table 3. Column 1 presents the results of the model without the interaction effects given by equation (1). We see that size, age, export, growth and business group affiliation do not have a statistically significant relationship with the perception of access to finance as an obstacle to the current operations of the establishments. Audit dummy variable has a statistically significant negative relationship with the dependent variable at the 0.01 level. The coefficient indicates that firms whose financial statements are checked and certified by external auditors are less inclined to see access to finance as an obstacle to their operations. Experience dummy variable also has a statistically significant negative relationship with the dependent variable at the 0.01 level. The coefficient shows that firms that applied for a loan or line of credit in the last fiscal year have a lower tendency to see access to finance as an obstacle.

Column 2 presents the results of the model given by equation (2) which includes the interaction effects. The statistically significant coefficient of the interaction effect of audit dummy variable and export variable shows that the effect of having audited financial statements on the inclination to see access to finance as an obstacle changes with the export intensity of the firm. The positive coefficient shows that audited firms with a higher percentage of sales that is exported have a higher tendency to see access to finance as an obstacle than firms with a lower percentage of sales that is exported. This finding can be the result of the uncertainty and failure risk that exporting carries (Amiti and Weinstein, 2011).

Dependent Variable: Obstacle Independent Variables	[1]	[2]
Size	0.00007	0.0001
	-0.942	-0.905
Age	0.002	0.0008
	-0.65	-0.833
Export	-0.0003	-0.0006
	-0.826	-0.767
Growth	0.11	0.095
	-0.221	-0.285
Group (Dummy)	-0.189	-0.156
	-0.131	-0.212
Audit (Dummy)	-0.515*	-0.518*
	0	0
Audit (Dummy) × Export		0.060**
		-0.029
Experience (Dummy)	-0.279*	-0.275*
	-0.003	-0.004
Experience (Dummy) × Export		-0.060**
		-0.014
R^2	0.1	0.12
F-Statistic	7.77	7.19
Prob (F-Statistic)	0	0

The null hypothesis that each coefficient is equal to zero is tested.
P-values in brackets.
*** Significant at 1% level.
** Significant at 5% level.
* Significant at 10% level.

Table 3: Regression estimation results

The interaction effect of experience dummy variable and export variable which is also statistically significant indicates that export intensity have an effect on the relationship between having applied for a loan or a line of credit in the previous year and the inclination to see access to finance as an obstacle. The negative coefficient shows that among the SMEs that made a recent credit application, those with a higher percentage of sales that is exported have a lower tendency to see access to finance as an obstacle than the ones with a lower percentage of sales exported. Eventually, we can say that being an export intensive firm strengthens the negative effect of the experience of a recent credit application on the inclination to see access to finance as an obstacle to the operations.

5. Conclusion

This paper examines the determinants of the perception of access to finance as an obstacle to the operations of Turkish SMEs. Determining these determinants for an emerging market is an important contribution to the literature because of the importance of SMEs for the economic prosperity of emerging markets. The results of the World Bank Enterprise Survey which was conducted in Turkey in year 2013 are used to compose the cross-sectional data set. The sample is composed of firms whose number of full time employees is less than or equal to 250.

The estimation results show that firm size, age, percentage of sales exported and business group affiliation do not have a relationship with the inclination to see access to finance as an obstacle. In line with our expectation, we find that firms that have audited financial statements have a lower tendency to see access to finance as an obstacle to their operations. However, this tendency decreases with an increase in the percentage of sales exported. This finding can be attributed to the credit-constraints faced by exporting SMEs created by their exposure to uncertainty and failure risk.

We also find that SMEs that made a recent credit application have a lower inclination to perceive access to finance as an obstacle. An increase in the percentage of sales exported strengthens this inclination. As a result, export intensive firms that made a credit application in the last fiscal year are less inclined to see access to finance as an obstacle than non-export intensive firms that made a credit application.

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HOW TO INTEGRATE ENTREPRENEURSHIP EDUCATION AND CREATIVITY INTO A BUREAUCRATIC ENVIRONMENT (CASE STUDY)

Abstract

Research has revealed that there is a positive correlation between entrepreneurship and economic growth. As a consequence, the European Commission is taking action on enhancing entrepreneurship and recommends appropriate entrepreneurship training in schools and higher education. Besides other factors, entrepreneurship education is often characterised by creativity, problem solving, interdisciplinarity and practice orientation. With respect to these aspects, universities might not be the right environment to launch an education for entrepreneurship and creativity. They are often inflexible institutions characterised by bureaucratic structures, laborious decision processes, and highly regulated procedures. Although they should teach entrepreneurship and creativity, they are caught up in bureaucracy and stagnancy themselves. Nevertheless, universities are obliged by government to contribute essentially to entrepreneurship education.

In this case study, we examined the integration of entrepreneurship education under the challenging circumstances mentioned above. The university in this case study is home to more than 32,000 students and 4,000 employees, 6 faculties, 76 departments, and about 120 study programs. Due to cooperation with other institutions, about 60,000 students are allowed to participate. The program in this study provides basics in management, entrepreneurship and intrapreneurship to increase general employability and to promote creativity, interdisciplinary thinking and entrepreneurial acting. The findings of our study indicate the importance of a setting that allows students to participate irrespective of their discipline or the progress in their studies. Moreover, it seems advantageous that students can customise the program according to their specific needs. The importance of flexible integration into regular academic studies has to be emphasised. In this study, we provide an adequate solution to master this challenge in a bureaucratic environment.

Keywords

bureaucracy, entrepreneurship education, integration, university

1. Introduction

Europe's new companies alone, particularly small businesses, generate more than four million new jobs every year (European Commission, 2013). In response to the growing importance of these companies, the European Commission is taking action on enhancing entrepreneurship in Europe. According to the European Commission, "entrepreneurship refers to an individual's ability to turn ideas into action. It includes creativity, innovation and

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risk taking, as well as the ability to plan and manage projects in order to achieve objectives." (European Commission, 2005, p. 17, 2006, p. 4). Education should therefore develop awareness of entrepreneurship from primary school to university. Introducing young people to entrepreneurship triggers their initiative and helps them to be more creative and self-confident (European Commission, 2006).

When considering the requirements of modern entrepreneurship education the question remains whether universities are the best choice for implementation. They are often inflexible institutions characterised by bureaucratic structures, laborious decision processes and highly regulated procedures. In other words, although these institutions should teach entrepreneurship and creativity, they are often caught up in bureaucracy and stagnancy themselves.

The aim of this paper is twofold. Firstly, we examine the main characteristics of entrepreneurship education at universities. For this purpose, we present a short overview of relevant literature and structure the findings to elaborate the main aspects. Secondly, we analyse the situation at the investigated university and show how entrepreneurship education and teaching for creativity was implemented in a bureaucratic environment. In this section, we examine the most important factors regarding structure, integration and content.

2. Entrepreneurship education and creativity

The relevance of entrepreneurship education has been growing ever since the first entrepreneurship class was held in 1947 in the USA, and especially from the 1980s on, when Drucker's *Innovation and Entrepreneurship* was published (Drucker, 1985; Katz, 2003). In literature, there is a consensus that entrepreneurship can be taught and there is evidence that entrepreneurial attributes can be positively influenced by entrepreneurship education (Gorman, Hanlon, and King, 1997). It impacts students' awareness of entrepreneurship as an alternative career path to employment and provides them with skills needed to start and successfully run their businesses (Gorman et al., 1997; Slavtchev, Laspita, and Patzelt, 2012). In contrast, there is also some research indicating that entrepreneurship education does not have the intended effects. For example, Oosterbeek, van Praag, and Ijsselstein (2010) discovered that the intention to become an entrepreneur could even be negative. They argue that this could be due to the more realistic self-perception of students and the following decrease in optimism that they can start a successful business on their own.

Bae, Qian, Miao, and Fiet (2014) define entrepreneurship education as education for entrepreneurial attitudes and skills and entrepreneurial intentions as a desire to own or start a business. In accordance, Jones and English (2004) describe entrepreneurial education as the "process of providing individuals with the ability to recognise commercial opportunities and the insight, self-esteem, knowledge and skills to act on them" (p. 416). Literature emphasises different key aspects in entrepreneurship education. Based on our literature review, entrepreneurship education should imply the following four parts:

Professional skills. Entrepreneurship education should provide (theoretical) management and entrepreneurship knowledge. Students should be able to manage a company, therefore it is necessary to teach them basic skills in traditional business disciplines, e.g. management, marketing, controlling, finance and accounting (Jones and English, 2004). At best, they also learn the basics about business environments and get some insights in macroeconomic correlations. A proper theoretical education will enable them to assess opportunities and threats as well as strengths and weaknesses of their business ideas. Many authors propose a mixture of professional competences and soft skills. For instance, Vesper and McMullan (1988) demand knowledge-based courses about entrepreneurship and functional core areas as well as skill-building courses and practice. Similarly, Plaschka and Welsch (1990) postulate that entrepreneurship education should include theory-based practical applications on the one hand, and creativity, multi-disciplinary and process-oriented approaches on the other.

Behavioural and attitudinal competencies. This leads us to the second part of proper entrepreneurship education, which refers to skill-building courses. This category covers all aspects of soft skills such as personality traits, communication, language, personal habits, and social manners. But it also includes competences that are more entrepreneurship-specific, like opportunity recognition, opportunity assessment, negotiation, leadership, risk management, conveying a compelling vision, commercialising a concept, value creation with new business models, marshalling resources, resource leveraging, guerrilla skills, focussing, tenacity resilience, self-efficacy, and building and using networks (e.g. Jones and English, 2004; Morris, Webb, Fu, and Singhal, 2013).

Many authors advocate courses in creativity, creative thinking, and creative problem solving (Morris et al., 2013; Plaschka and Welsch, 1990; Solomon, Yar Hamidi, Wennberg, and Berglund, 2008; Vesper and McMullan, 1988). Amabile (1997) defines creativity as the "production of novel and appropriate solutions to open-ended problems in any domain of human activity" (p. 18) and entrepreneurship as the "successful implementation of creative ideas to produce a new business, or a new initiative within an existing business" (p. 18) and therefore entrepreneurial creativity as "the generation and implementation of novel, appropriate ideas to establish a new venture" (p. 20). In that context, Solomon et al. (2008) found that exercises in creativity can be used to raise the entrepreneurial intentions of students in entrepreneurship education.

Practice. Another very important point is practice. Literature suggests a vast field of practice-orientated activities, like working in start-ups, writing business plans, meeting entrepreneurs, simulations, videos of new venture start-ups, role play, and business games (e.g. Clouse, 1990; Vesper and McMullan, 1988). Neck and Greene (2011) suggest starting businesses as coursework, serious games and simulations, design-based thinking, and reflective practice as new methods in entrepreneurship education. Rasmussen and Sørheim (2006) also state the relevance of learning-by-doing activities in a group setting and a network context. Jones and English (2004) demand a teaching style that is action-oriented, encourages experiential learning, problem solving as well as project-based learning, and is supportive of peer evaluation.

Awareness and self-assessment. The last part of entrepreneurship education is about awareness and self-assessment. This part is for some reasons crucial, as it allows students to discover their specific abilities, informs them about career options, and teaches them to assess which career – entrepreneur or manager – is most suitable for them (Graevenitz, Harhoff, and Weber, 2010). Research is ambiguous regarding the effects in this matter. On the one hand, some results suggest that initially undecided students are most likely to change their beliefs when attending an entrepreneurship class (Graevenitz et al., 2010). On the other hand, Slavtchev et al. (2012) show a positive effect of entrepreneurship education on students' intentions to become entrepreneurs in the long term (after some time in paid employment), but a negative effect on their intentions in the short term (immediately after graduation). This could be due to the fact that entrepreneurship education provides more realistic perspectives on what it takes to be an entrepreneur (Oosterbeek et al., 2010; Slavtchev et al., 2012).

3. Bureaucratic environment

In this section, we take a short look at universities, which are often obliged by government to contribute essentially to entrepreneurship education. The European Commission (2006) has also recommended fostering entrepreneurship in higher education and including entrepreneurship as an objective of education into curricula. Entrepreneurship should be embedded into curricula across all levels of education before the end of 2015 (European Commission, 2013).

But with respect to the above mentioned characteristics of entrepreneurship education, universities might not be the right environment to launch education for entrepreneurship and creativity. There are some obstacles that could interfere with these efforts:

- **Bureaucracy**: Universities are often bureaucratic institutions. They have standardised rules related to curricula, courses, lecturers, and content as well as the kind of teaching. These rules are defined in numerous laws and can restrict the options for a modern and unconventional education for entrepreneurship or creativity.
- **Decision-making**: Complicated and lengthy procedures often stop novel approaches even before they get started. Strong support from opinion makers is required to overcome laborious decision processes and bureaucratic barriers.
- **Structures**: Universities are characterised by inflexible structures. This problem is twofold. On the one hand, there are long-established departments and staff members who fear to lose their vested rights. On the other hand, there are strict rules for curricula that complicate the establishment of entrepreneurship education within these programs. For both reasons it is hard to implement interdisciplinarity that is strongly needed in entrepreneurship education.
- **Financing**: The unpleasant nature of budgets is that they are restricted. If somebody gets more money, another one will get less. This "mechanism" interferes with new disciplines and, due to distribution battles, limits them in their development.
- **Academia**: The scientific world is characterised by objectivity, accurateness, prudence, standardised methods, projectable procedures, and theoretical issues. Entrepreneurship focuses on practical issues, a high factor of unpredictability, exceptional methods, emotions, creativity, and courage. This should not be misunderstood: creativity, for example, is just as important for academia as accuracy

for entrepreneurship. They are not opposite poles, but often choose opposite approaches.

These issues have to be considered when implementing entrepreneurship education and appropriate actions have to be taken subsequently. Problems that affect the quality of entrepreneurship education and influence the entrepreneurial mindset have to be prevented.

4. Case study

In this section we analyse the situation at the investigated university and elaborate the most important factors regarding structure, integration and content of entrepreneurship education at an institution that meets the above mentioned aspects.

4.1. Preconditions and objective of the program

The location in this case study has more than 275,000 residents and about 60,000 students at eight universities or colleges of higher education. The investigated university itself is home to about 32,000 students and 4,000 employees, 6 faculties and 76 departments, offering more than 120 study programs.

The situation is characterised by a low affinity to entrepreneurship as a possible way to create one's own future. Only a very small number of students considers becoming an entrepreneur. Entrepreneurship education in the region faces challenges such as complex study law rules, a conservative mindset with regard to a "traditional" career, and fear of failure. Furthermore, the universities and disciplines have different cultures and socialisations.

To counteract these problems, the universities at the site and a local academic incubator established an inter-university program called TIMEGATE. The project name TIMEGATE stands for Transfer Initiative for Management and Entrepreneurship Basics, Awareness, Training and Employability. TIMEGATE provides essential basics about entrepreneurship and intrapreneurship to increase general employability and promote interdisciplinary thinking and acting. It is the answer to the challenge of creating a regional entrepreneurship ecosystem.

Specific objectives are:

- to position entrepreneurship as a bridge and crosscutting issue for students of all disciplines and to break down bureaucratic structures between universities,
- to integrate entrepreneurship into relevant networks at the site and to use regional advantages (young, well-educated environment, comprehensive industry spectrum),
- to develop an independent and formative mindset and to ensure entrepreneurial thinking and acting within the organisation, and
- to provide practically oriented content through external experts and enable students to learn from managers and entrepreneurs.

The whole program, which is free of charge for students, is funded by the involved universities and the Ministry. The latter provides extra funding for this cooperation between universities. This additional budget is very important for acceptance within the universities because it highlights the relevance of entrepreneurship education for the Ministry while avoiding distribution battles involving traditional programs and departments at the same time. For this reason, decision processes could be accelerated, enabling rapid compilation of the fundamental structure of the program with the support of university administration.

4.2. Structure of the program

In the program's development phase, it was necessary to decide how profoundly the program should be integrated into existing study curricula. Due to the fact that many legal and administrative regulations would have limited the program, it was decided to integrate it by means of elective courses, which are available and open to all students of the participating universities. Since all curricula require elective courses amounting to nine or more ECTS, it is possible for students to integrate entrepreneurship education into their regular studies and to attend courses without "losing" time. Furthermore, students can participate irrespective of their studies and academic progress.

Students can acquire certificates to formally confirm qualifications for the labour market. Those certificates still have numerous options to choose from, but also require the completion of certain obligatory courses.

4.3. Content of the program

The program consists of two certificates (Figure 1). The Basic Entrepreneurship Certificate includes three courses with one ECTS each. Building on the Basic Entrepreneurship Certificate, it is possible to earn an Advanced Certificate in which students can deepen content and can set individual priorities according to their own needs. For the Advanced Certificate it is mandatory to finish the Basic Certificate first. Furthermore, it is necessary to choose between the *School of Creativity* and the *Garage*. The former is designed for students without a concrete business idea to learn creativity techniques. In the latter, the students can refine their business concepts or work on their start-up. Additionally, students have to complete three more elective courses based on their needs (Figure 1: Individual courses). Over 30 courses are available in three major fields. Firstly, there are core business courses such as accounting, financing, marketing, leadership and management, and secondly, courses for e.g. soft skills, personality, psychology and creativity. Thirdly, the final part focuses on practical insights in specific branches of industry, for example pharmacy, health, and manufacturing. The lecturers are mostly experts with practical experience. They provide relevant knowledge in their areas and ensure practical relevance in teaching.

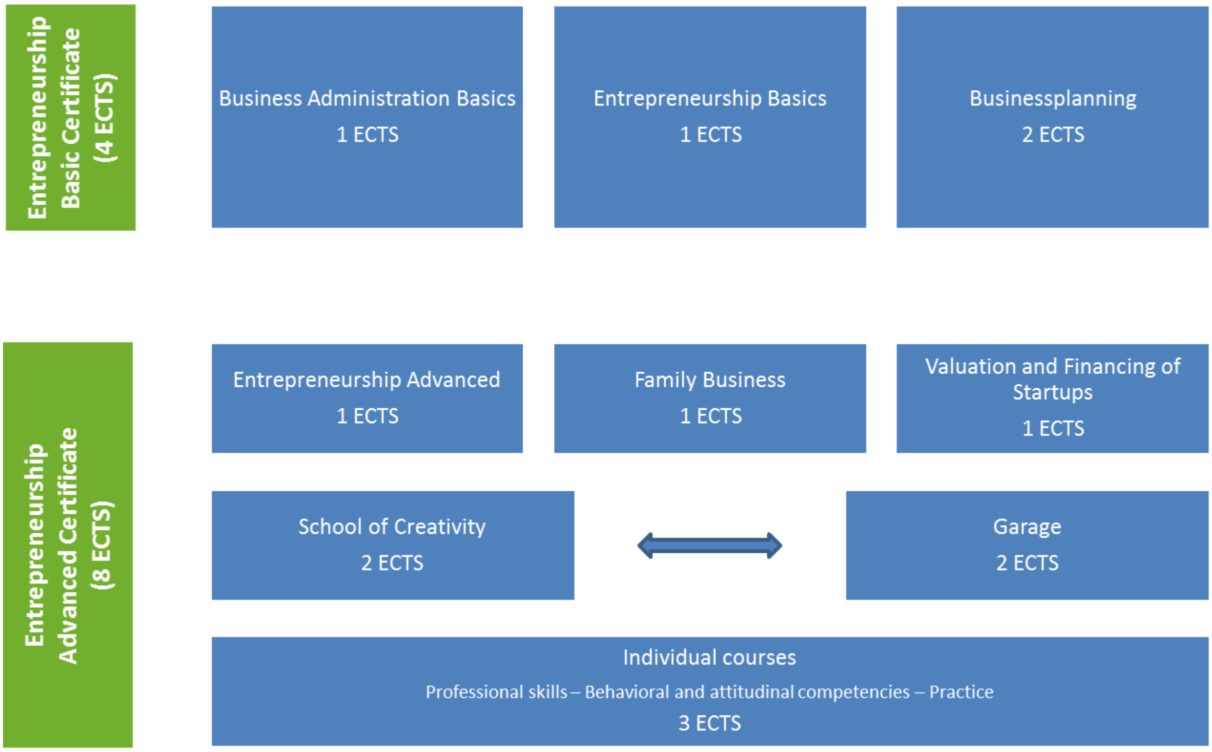

Figure 1: Entrepreneurship School
(Source: Authors' illustration)

According to the literature review, entrepreneurship education should target professional competences as well as behavioural and attitudinal competencies, practice, awareness and self-assessment. The program focuses on the following aspects:

- **Professional skills**: The *Business Administration Basics* and *Entrepreneurship Basics* courses, in particular, provide fundamental knowledge. Furthermore, students can attend core business lectures when they have to select their individual courses in the Advanced Certificate. The aim is to give interested students useful tools for an upcoming start-up phase.
- **Behavioural and attitudinal competencies**: The *School of Creativity* course enables students wishing to start a company to independently learn application-oriented techniques and methods for a structured development of start-up and business ideas. Students should get insights into creativity techniques and learn which concepts and methods are primarily used in economy and practice. More courses focusing on soft skills and personal competences are available in the context of the individual courses they have to choose.
- **Practice**: The whole program provides a high level of practice orientation. One special course is the *Garage*. Students apply preliminarily suggesting their ideas and providing an executive summary. After their successful admission to the *Garage*, students are accompanied by experienced mentors. They work in interdisciplinary teams for one semester to develop their own business models. Workshops on storytelling, legal basics, design thinking and e-business are currently available. The course defines basic aspects related to starting a venture. The 18 mentors form a key part of the course. They can be booked within the semester for coaching sessions

and advise on issues such as marketing, sales, design or even financing and software development. Through individual and personal coaching, open questions are handled competently and quickly.

- **Awareness and self-assessment**: This program leads to a better view of entrepreneurship as a very important topic. The main point is that it is not limited to business students. Because of the collaboration of local universities, it ensures that students of all disciplines become aware of entrepreneurship as a possible career option. The program will enable them to better assess themselves and their business ideas. Students learn about their strengths and weaknesses and find out whether they are qualified as an entrepreneur or not. Events such as panel discussions with entrepreneurs or start-up cafes lead to a higher awareness and complete the program.

4.4. Specifics of the program

This case study provides some important insights for the implementation of an entrepreneurship program at university. The following issues characterise the project:

- Collaboration between universities on the site enables entrepreneurship education for all disciplines and not just for the obvious ones. That not only provides an interdisciplinary approach, but ensures that all students become aware of this career option.
- Integration into curricula through elective courses allows students to attend the program without losing time doing their regular studies, irrespective of their academic progress. Furthermore, this approach avoids bureaucratic obstacles, opens up flexibility in implementation, and also allows for creative solutions, as it is not necessary to adapt curricula with regard to their content or extent.
- The program can be tailored to the personal needs of the students, as it offers a high number of optional courses. Hence, students can focus on their business ideas.
- Universities position themselves as partners and support the students before, during and after the founding. Network effects and synergies are used by integrating non-university partners.
- A high level of practice within the program ensures relevance for the economy.
- Entrepreneurship education is a pillar of university policy.

5. Conclusions

The economic relevance of entrepreneurship has increased constantly, and as a result, political decision makers in Europe and the United States have started to make increased efforts to foster entrepreneurship at schools and universities.

Literature reveals that proper entrepreneurship education should include professional skills (basic knowledge in core areas of management and entrepreneurship), behavioural and attitudinal competencies (e.g. soft skills, creativity, opportunity recognition, negotiation), practice (hands-on activities, e.g. business planning, starting an own business, interaction with start-ups), and courses for awareness building and self-assessment. The latter point is not only important for drawing attention to an entrepreneurial career, but also for identifying and filtering those students with the highest potentials. In that sense, it can protect students from choosing the “wrong” career. Accordingly, there is evidence that entrepreneurship education does not necessarily have a positive effect on students’ intentions to become an entrepreneur in the short run, for it provides them with a more realistic perspective on what it takes to be an entrepreneur (Slavtchev et al., 2012).

In this case study, we examined the implementation of entrepreneurship education and creativity at a university. Universities are characterised by bureaucracy, laborious decision processes, inflexible structures and lengthy processes, restricted budgets and an ambiguous relationship between “theoretical” academia and “practical” entrepreneurship. For this reason, university might not be the right environment to launch education courses for entrepreneurship and creativity.

Our findings indicate the importance of a setting that allows students to participate irrespective of their discipline or study progress. Moreover, it seems advantageous that students can tailor the program to meet their specific needs. The importance of flexible integration into regular academic studies has to be emphasised.

Although at present universities may sometimes be stagnant and cumbersome institutions, they are crucial for creating new ideas and finding novel solutions. Therefore, universities and start-ups are more similar than expected.

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THE FUTURE OF SOCIAL POLICY IN EUROPE: AN ANALYSIS OF ATITUDES TOWARD SOCIAL WELFARE

Abstract

One of the tasks of social policy is to support economic development. Governments invest in social policy to protect citizens from social risks (for instance, in the labor market). In this sense, economic policy and social policy are strongly linked. The different choices governments have with respect to social policy lead to variations in welfare states. Typically, scholars have divided welfare states into three groups: social democratic, liberal, and continental countries.

This study examines citizens' attitudes toward social policy in 23 European countries, and especially within the three groups of welfare states. Attitudes toward social welfare are divided into two parts: respondents' opinions regarding national policy and their attitudes toward poverty. The study focuses on the connections between the type of welfare state and its citizens' attitudes toward social policy. The study also examines whether so-called situational factors (e.g., the level of income inequality, social expenditure, and social insurance) influence the social welfare attitudes of citizens. The data, which were gathered in 2012, are based on the European Social Survey's (N = 43,897) sixth round.

The results show that the situational factors have an important role, especially in how citizens evaluate national social policy. However, simultaneous analyses of all the situational factors and social welfare attitudes suggest that the situational factors have only an indirect influence on attitudes toward poverty, such that respondents' opinions of national policy have a mediating role. In this sense, the results support a weak interpretation of the influence of situational factors on attitudes toward social welfare.

Furthermore, the results show that attitudes toward social welfare are connected to the types of the welfare states, in this analysis, especially in the Nordic (particularly Finland, Norway, and Sweden) and liberal countries (particularly Great Britain and Ireland). In these countries, unlike others, respondents' opinions regarding national policy and attitudes toward poverty are positively related. However, according to a more detailed analysis, the Nordic and liberal countries can be separated from each other. The group of continental countries was excluded from the final analysis because it seemed not to be a coherent group, as the original welfare-state typology indicated.

Keywords

social policy, socal welfare attitudes

1. Introduction

One of the tasks of social policy is to support the economic development to which it contributes, for instance by optimizing the relationship between the citizens and the labor market. Attitudes toward social welfare indicate how citizens appreciate social policy in

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general, and especially how they evaluate the government's social-policy measures. In a well-functioning society, citizens' opinions are taken into account in governmental policies. To be effective, social policy must be accepted by the citizens it is meant to serve. For this reason, scholars have focused their attention on attitudes toward social welfare (Ervasti, 2012; Gërxhani, Koster, 2012; Larsen, 2008; Salmina, 2014; Svalfors, 1997; van Oorschot, 2006).

Attitudes toward social welfare are connected to the level of national social policy. For instance, Blekesaune and Quadagno (2003) emphasize the idea that situational factors influence public attitudes toward welfare-state policy. Situational factors refer to the level of national social policy that can be expressed by various social-policy indices (for instance, those related to social expenditures and income inequality).

The study examines citizens' attitudes toward social welfare in 23 European countries and whether situational factors (the level of income inequality, social expenditures, and social insurance) influence these attitudes, which, in this case, are those focused on poverty and income inequality. The analysis is performed using the framework of the welfare-state typology (Esping-Andersen, 1990).

2. Concepts

2.1. Attitudes Toward Social Welfare

Although an attitude is often understood to be a personal trait, some researchers emphasize it as a social and contextual construct (e.g., de Rosa, 1993). According to Eagly and Chaiken (1993), the various definitions of attitude feature two common properties. First, an attitude refers to an object; this object can be concrete or abstract, specific or general, but in any case, an attitude always has a target. The second aspect of attitude is evaluative; the evaluation can have various dimensions, such as good or bad, harmful or beneficial, pleasant or unpleasant, and likable or unlikable (Ajzen, 2001).

The concept of attitudes toward social welfare has referred to the responsibility of the state (Valdimarsdóttir, 2010), to attributions for poverty (e.g., Blomberg, Kallio, Kroll 2010), to attitudes toward welfare policy (Bullock, 2004), and to opinions regarding social welfare services and social security benefits (Muuri, 2010). In this study, attitudes toward social welfare focus on those related to poverty and income inequality. Attitudes are studied in two forms: as respondents' opinions regarding national policy and as a general attitude toward poverty.

Previous studies reveal that many factors influence attitudes toward social welfare. Political ideology significantly affects attitudes (e.g., Valmidarsdóttir, 2010). The field of study and level of education also affect attitudes, although the results are contradictory (cf. Pfeifer, 2009). Additionally, studies show that women, more than men, support the welfare state (Blekesaune, Quadagno, 2003). Age is also a significant factor in attitudes toward welfare. (Valdimarsdóttir, 2010). According to Blekesaune and Quadagno (2003), situational (i.e., unemployment) and ideological (i.e., egalitarian ideology) factors influence public attitudes toward welfare state policy.

2.2. Situational Factors

Welfare states can be organized into groups according to situational factors. Esping-Andersen’s (1990) classic definition divides welfare states into three groups: the *liberal* (Anglophone countries), the *conservative* (continental Europe and Japan), and the *social democratic* countries (Denmark, Finland, Iceland, Norway, and Sweden). The different groups of welfare states have different strategies for tackling poverty and inequality.

The *welfare state* is a definition that expresses the level and intensity to which the state acts in the protection and promotion of the well-being of its citizens. The social democratic model emphasizes the state’s central role in the society, but the liberal model focuses attention on the individuals’ own responsibility and tries to limit the state’s role as much as possible. The Nordic model is financed mostly by taxes, but the liberal model favors privately financed social security. The conservative model is on a level between the Nordic and liberal models (Powell, Barrientos, 2004; Ferragina, Seeleib-Kaiser, 2011).

In his classic welfare state analysis, Esping-Andersen (1990) uses the concept of *decommodification* to express the extent to which the state invests in its citizens’ “immunization from market dependency.” Scruggs (2014) uses the concept of *generosity* for the same purpose: to indicate the level of social security. Both concepts are operationalized by measuring situational factors to indicate the level of social security. Esping-Andersen (1990) calls it the “decommodification index,” and Scruggs (2014) calls it “the generosity indices.” In this study, situational factors focus on social insurance, social expenditures, and income inequality. The factors are viewed as national measures that also indirectly refer to the groups of welfare states: the social democratic model (later in this paper: the Nordic countries), the liberal model, and the continental model.

3. Research question, hypotheses, and method

This study examines citizens’ attitudes toward social policy in 23 European countries. The concept of *attitudes toward social welfare* is divided into two parts: respondents’ opinions about national policy and their attitudes toward poverty. The respondents’ opinions regarding national policy focus on their evaluation of governmental measures against poverty and income inequality. In contrast, the term *attitude toward poverty* refers to poverty and inequality in a more general view, as a democratic value.

The study examines whether situational factors (the level of income inequality, social expenditures, and social insurance) influence citizens’ attitudes toward social welfare. Furthermore, the analysis is done in the framework of the welfare-state typology. The analysis is based on the following hypotheses:

H1: Situational factors influence respondents’ opinions regarding national policy.

H2a: Situational factors directly influence attitudes toward poverty; (or)

H2b: Situational factors indirectly influence attitudes toward poverty via opinions regarding national policy.
H3: The welfare state models differ from each other on the basis of social welfare attitudes.

The analysis was carried out using normal statistical methods. The sum variables were formed using factor analysis (generalized least squares, Varimax with Kaiser normalization). The reliabilities of the sum variables were calculated using Cronbach's alpha, and the normality of the distributions was examined using the Kolmogorov-Smirnov test. The distributions of variables were not completely normal; however, parametric methods were used because the distributions were nonetheless close to normal and the size of the data set was sufficient. Pearson's coefficient was used to measure correlations. Statistical analyses were done using linear regression analysis and analysis of variance (one-way ANOVA).

4. Primary data: social welfare attitudes

The primary data, which were gathered in 29 countries in 2012, are based on the European Social Survey's (ESS) sixth round. In particular, the final selection of the countries was matched to the available data on social policy factors; thus, 23 countries were represented in the final data sample (N = 43,897) (see Appendix 1).

The primary data, which focused on individual public attitudes toward social welfare, are divided into two sum variables:

The sum variable of "attitude toward poverty" was constructed from two items: how important it is to a democracy, in general, for a government to (a) protect all citizens against poverty, and (b) take measures to reduce differences in income levels. The sum variable is called "attitude toward poverty."

The second sum variable focused on respondents' opinions regarding national policy: Specifically, how well do the following statements describe the situation in your country? (a) The government protects all citizens against poverty, and (b) the government takes measures to reduce differences in income levels. The sum variable is called "respondents' opinions regarding national policy."

The response categories were based on a 0–10 scale where *0* means "not at all important" and *10* means "extremely important" (77 declined to answer, and 99 stated that they did not know). The reliabilities exhibited a good level for both sum variables. Country-based results in which Cronbach's alpha was below 0.6 were excluded.

5. Secondary data: situational factors

Welfare states have access to various kinds of social policy instruments for reducing poverty and income inequality. Typically, the instruments are based on redistribution, social

insurance, and social benefits. In this study, the following situational factors are used to describe the level of social policy in each country.
Economic equality is a situational factor which typically is measured by the Gini coefficient. It is a relative measure, and its interpretation is therefore controversial; however, it is widely used as an indicator of inequality. The Gini coefficient measures the inequality among values of a frequency distribution (e.g., levels of income). A Gini coefficient of 0 expresses perfect equality, and a Gini coefficient of 1 (or 100%) expresses maximal inequality among values. The data were retrieved from Eurostat (Statistical Office of the European Communities).

Social insurance can be defined as a program by which social risks (i.e., unemployment, sickness, and retirement) are transferred to, and pooled by, an organization, often governmental, that is legally required to provide certain benefits. The measure of social insurance is based on the Comparative Welfare Entitlements Dataset, which provides comparable information about national welfare programs around the world (Scruggs, 2014). In this study, the focus is on the following social insurance programs: unemployment insurance, sickness insurance, and public pensions.

Social (protection) expenditures can be counted in many different ways, but in this study they are defined as a percentage of gross domestic product. The expenditures comprise the following: social benefits, which consist of transfers, in cash or in kind, to households and to individuals to relieve them of the burden of a defined set of risks or needs; administration costs, which represent the costs charged to the plan for its management and administration; and other expenditures, which consist of miscellaneous expenditures by social protection plans (payment of property income and other). The data were retrieved from Eurostat.

6. Results

6.1. Respondents' Opinions Regarding National Policy

The respondents' opinions regarding governmental measures against poverty and income inequality vary significantly between the countries. On a scale of 0–10, the lowest mean of the variable of respondents' opinions about national policy was in Bulgaria (1.175), and the highest was in Norway (6.282). Furthermore, based on all the data, the sum variable of respondents' opinions regarding national policy correlates positively with social expenditures ($R = .702^{**}$) and negatively with the Gini index ($R = -.524^{*}$). In this sense, the respondents' opinions are in a logical relation to the country's capacity for taking measures against poverty and inequality. The more a country invests in social policy, the higher citizens assess its ability to implement measures against poverty and inequality.

The respondents' opinions regarding government's ability to reduce poverty and income inequality was examined in more detail by using regression analysis. It was assumed that situational factors, such as the Gini index, social expenditures, and social insurance, influenced the respondents' opinions. According to the regression analysis, the respondents' opinions about government's ability to reduce poverty and income inequality can be explained by the level of social expenditures and by the Gini index, as the following regression analysis shows (see Table 1).

	Model 1			Model 2		
R Square	.645			.642		
F	10.911***			17.911***		
	Beta	t	Sig.	Beta	t	Sig.
Constant		2,066	.054		2,336	.030
Gini	-.402	-2.739	.013	-.395	-2.886	.009
Social expenditures	.620	4.188	.001	.619	4.527	.000
Social insurance	-.019	-.129	.899			

Table 1: Regression Analysis of Opinions Regarding Government

The result is consistent with the theoretical assumption, because the sum variable of respondents' opinions regarding national policy focuses only on the government's ability to reduce economic inequality, which can be measured by the Gini index; furthermore, the sum variable focuses on actions against poverty, which governments can reduce via social investments (expenditures). According to this analysis, social insurance is less important than the other two factors.

6.2. Attitudes Toward Poverty

Throughout European countries, respondents shared the view that reducing poverty is an important democratic value. According to the European Social Survey, the mean of the sum variable of the attitudes toward poverty varies between 7.59 (the Netherlands) and 9.11 (Spain) on a scale of 0–10. Although respondents see measures against poverty as a democratic value, it is interesting to note that they correlates negatively with social expenditures ($R = -.427^*$) and positively with the Gini index ($R = .430^*$). This result indicates that citizens in countries with lower social investments and higher inequality levels support measures against poverty and income inequality even more than citizens in countries with higher social investments and lower inequality levels.

The respondents' attitudes toward poverty were also examined by regression analysis (see Table 2), in which the poverty attitude was explained by situational factors (the Gini index, social expenditures, and social insurance); additionally, the sum variable of the respondents' "opinions regarding national policy" was taken into account in the analysis.

	Model 1			Model 2			Model 3		
R Square	.492			.470			.411		
F	4.122*			5.325**			6.976**		
	Beta	t	Sig.	Beta	t	Sig	Beta	t	Sig.
Constant		7.058	.000		17.545	.000		23.242	.000
Gini	.185	.861	.401	.333					
Social expenditures	.270	1.055	.306	.243	1.364	.189	.375	1.558	.135
Social insurance	.272	1.481	.157	.970	1.358	.191			
Opinions regarding national policy	-.744	-2.565	.020	-.880	-3.635	.002	-.846	-3.512	.002

Table 2: Regression Analysis of Attitudes Toward Poverty

According to the results, the sum variable of poverty attitude is the one most influenced by the sum variable of respondents' opinions regarding national policy. The sum variables are tightly connected to each other, but the situational factors do not directly influence attitudes toward poverty.

6.3. Relationships Between the Sum Variables

Based on all the data, the sum variable of respondents' opinions regarding national policy correlates negatively with the sum variable of attitudes toward poverty (R = -.145**). This result refers to a situation in which a government's ability or will to reduce poverty and income inequality is evaluated to be lower than the citizens' own priorities of reducing poverty and inequality.

On the other hand, in the Nordic and liberal countries, the correlation is positive: 0.119*** in Finland, 0.168*** in Norway, 0.115*** in Sweden, 0.127*** in Britain, and 0.076*** in Ireland. From a social-policy perspective, it is surprising that the liberal and Nordic countries belong to the same group with respect to this dimension. For instance, Britain is typically seen as an example country of liberal social policy, which generally differs significantly from the Nordic countries. However, one needs to be reminded that this analysis focuses only on a portion of the Nordic countries and on a few of the liberal countries.

6.4. Relationship Between the Nordic and Liberal Countries

Although the sum variables of respondents' opinions about national policy and attitudes toward poverty correlates positively, the Nordic and liberal countries groups were possible to separate from each other by using variance analysis. In the analysis, attention focused on the sum variable of respondents' opinions regarding national policy. The variance analysis indicates statistically significant differences between the groups ($F[4, 10339] = 101.349$, $p = .000$). The Scheffé test was used to find the exact difference (cf. Table 3).

Country	N	Mean		SD
		Subset 1	Subset 2	
Great Britain	2,198	5.131		2.548
Ireland	2,564	5.166		2.772
Finland	2,162		5.969	2.026
Sweden	1,818		6.091	2.572
Norway	1,602		6.282	2.013
Sig.		.995	.002	

Note. The Scheffé test (subset for d = 0.001).

Table 3: Respondents' Opinions of National Policy in the Liberal and Nordic Countries

The liberal and Nordic countries were sorted into separate groups. Great Britain and Ireland formed a coherent group ($p = .995$), but there were some differences between Finland, Sweden, and Norway although these countries were sorted into the same group ($p = .002$). Furthermore, it is important to add that Denmark and Iceland, which belong to the group of the Nordic welfare-state group, had already been excluded in the previous phases of the analysis because of weak correlations between the sum variables.

7. Conclusions

The study examined whether situational factors (the level of income inequality, social expenditures, and social insurance) influence citizens' attitudes toward social welfare. Furthermore, the study focused on the connection between the type of the welfare states and citizens' attitudes toward social welfare. According to the analyses, the following answers can be provided in response to the hypotheses.

First, the assumption that situational factors influence attitudes toward social welfare (respondents' opinions regarding national policy) is supported. In particular, the level of social investments and economic equality directly influence citizens' opinions about national policy. In this sense, Hypothesis 1 is supported.

Second, after analyzing all situational factors and social welfare attitudes simultaneously, it seems that the situational factors indirectly influence the sum variable of attitudes toward poverty, such that the sum variable of respondents' opinions about national policy has a mediating role. Therefore, Hypothesis 2a is rejected, and Hypothesis 2b is supported. In addition, the result emphasizes a weak interpretation of situational factors' influence on attitudes toward social welfare (cf. Blekesaune, Quadagno, 2003).

Third, the welfare-state models differ from each other on the basis of attitudes toward social welfare. In the Nordic and liberal countries, the sum variables of "respondents' opinions regarding national policy" and "attitude toward poverty" were positively related; this was in contrast to the other countries, in which they were negatively related. However, according to a more detailed analysis, the Nordic and liberal-country groups can be separated from each other. The group of continental countries was omitted from the final analysis, since much further analyses are needed before the results can be reported. In this respect, Hypothesis 3 is supported.

In general, situationality influences citizens' satisfaction with governmental measures against poverty and inequality, which is indirectly (negatively) related to the notion on how important the government's measures against poverty and income inequality are viewed among citizens. From a social policy perspective, this presents a positive opportunity: Concrete social problems create dissatisfaction with the government, which increases the citizens' opinion about the significance of social policy. Furthermore, it can be assumed that in a democratic society, citizens' opinions also influence the implementation and practice of social policy. That is, the situationality of attitudes toward social welfare implies a certain kind of self-correction mechanism in social policy. However, the mechanism of self-correction requires a well-functioning democracy, in which citizens' opinions are taken into account in governmental policies; on the other hand, it also requires financial resources, which the government can use for social policy reforms.

Situationality might also mean that citizens' satisfaction with governmental policies may lead to a decline in the significance of social policy and consequently to a gradual reduction of social policy. If social policy is taken for granted, it may become less meaningful among citizens. However, according to this study, satisfaction with governmental policies in the Nordic and liberal countries did not negatively influence attitudes toward poverty; on the contrary, it positively influenced them. Thus, social policy seems to be on solid ground, and citizens' satisfaction does not erode the welfare-state's attitudinal base.

There were some limitations with respect to the results of this study. First, the fact that welfare-state attitudes were approached only on a general level was a limitation of this study. In addition, individual situational factors and analyses were excluded from the presentation. Second, the analysis is based on two sum variables, which are constructed from only two items. Third, the sum variables focused narrowly on poverty and inequality, although social-welfare attitudes can also be seen as a broad phenomenon. There are many other factors that influence attitudes toward social welfare. Therefore, much more research and social analysis is required to demonstrate the relationships between social-welfare attitudes and social factors. However, the data are comprehensive, and their reliability is good.

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Appendix 1. Material: List of accepted countries.

Country	N	alpha >.60 (Sum variables)	Social insurance	GINI	Social expenditure	Accepted
Albania	1200					
Belgium	1859	x	x	x	x	x
Bulgaria	2218	x	x	x	x	x
Switzerland	1460	x	x	x	x	x
Cyprus	1115	x				
Czech	1966	x	x	x	x	x
Germany	2950	x	x	x	x	x
Denmark	1619	x	x	x	x	x
Estonia	2329	x	x	x	x	x
Spain	1853	x	x	x	x	x
Finland	2163	x	x	x	x	x
France	1960	x	x	x	x	x
Britain	2204	x	x	x	x	x
Hungary	1962	x	x	x	x	x
Ireland	2596	x	x	x	x	x
Israel	2507	x				
Iceland	746	x		x	x	x
Italy	947	x	x	x	x	x
Lithuania	2058	x	x	x	x	x
Netherlands	1833	x	x	x	x	x
Norway	1608	x	x	x	x	x
Poland	1873	x	x	x	x	x
Portugal	2137	x	x	x	x	x
Russia	2483	x				
Sweden	1825	x	x	x	x	x
Slovenia	1217	x	x	x	x	x
Slovakia	1824	x	x	x	x	x
Ukraine	2177	x				
Kosovo	1297	x				
Total	54676					43897

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Domagoj Cingula[2]

WHEN ABDUL MEETS DAVID – DEVELOPING A RESPONSIVE REGULATORY SYSTEM FOR ISLAMIC FINANCIAL INSTITUTIONS: A CASE STUDY OF AUSTRALIA

Abstract

Islamic Financial Institutions serve as a substantial potential opportunity for the Australian economy given the steady growth of the Islamic banking, its closeness to the 60% of the Muslim who reside in the Asian countries and Australian Federal Government's 'Asian Century Strategy'. Though Islamic financial institutions have expanded significantly over the recent two decades in Australia, they face a laissez faire market, which failed to address their particular regulatory needs. Operating in a conventional banking favoured environment without special regulatory treatment, the Islamic financial institutions may give in to competition at the risk of jeopardising Shari'ah compliance in Australia. Taking a risk-based perspective, a responsive regulatory system is developed, incorporating self-regulation such as the IFSB Standards, a black-letter laws and the hybrid, responsive to the business characteristics and corporate governance. A Seven-stage model was also developed to operationalise the responsive regulatory framework. This study may shed light on the development of Islamic Financial Institutions to be introduced into a new market in the advanced economies similar to Australia.

Keywords

Responsive regulation, Islamic financial institutions, case study

Executive summary

The purpose of this paper was to identify the unmet regulatory needs of Islamic financial institutions in Australia and to develop policy options to cater to such unmet needs on the condition that no negative externalities were to incur to the existing financial service providers. Given the uniqueness of the Islamic financial institutions, this report challenged the extant 'one size fits all' regulatory model in the Australian financial service sector by proposing a new responsive regulatory framework which has a strong focus on the interests of stakeholders rather than shareholders. Furthermore, the paper argues that the responsive regulatory model yields more efficient outcomes in regulatory enforcement comparing to the other alternatives.

The paper analysed the demand and supply of Islamic finance in the global context and identified the potential opportunities for Australia. Then the paper went on to review the current financial regulatory and governance system in Australia (Figure 1) and identified the regulatory gap for Islamic financial institutions.

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After taking both the distinct features of the Islamic financial institutions and their unmet financing needs into consideration, it is recommended that the proposed responsive regulatory framework would be the most suitable option due to its economic efficiency, suitability, accountability and sustainability features. A seven-stage model (Figure 4) is developed accordingly to operationalise the responsive regulatory model (Figure 3). The establishment of the Shariah Supervisory Board has been used as an example to illustrate how the proposed models may be applied to the improvement of governance and regulation of Islamic financial institutions in Australia.

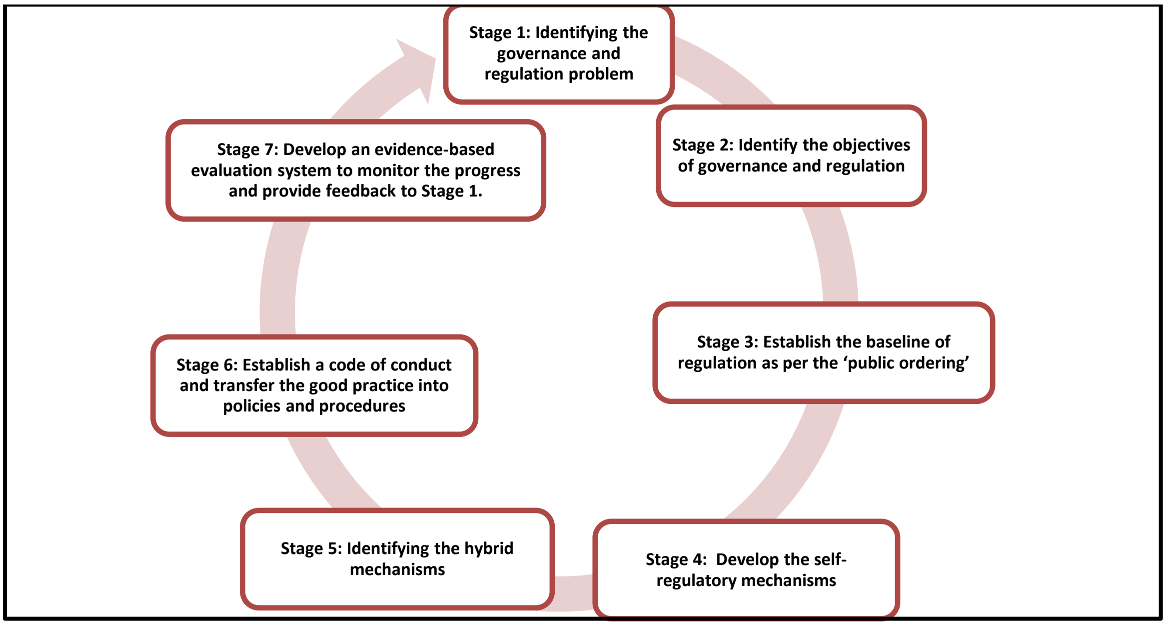


Figure: A Seven-Stage Responsive Regulatory Model for Islamic Financial Institutions in Australia

1. Introduction

Abdul who come from an Islamic background in Australia is keen with establishing an Islamic financial service company to serve people with similar religious belief like him. He did not realise how few Islamic finance service providers are in Australia. He approached an Australian commercial banker David who comes from a Western background. David intends to introduce Islamic finance into his company. But both David and Abdul are not clear about the regulations that they may face and how they can lobby for a more pleasant regulatory environment. This paper intends to help David and Abdul to understand the regulation and propose a better regulatory framework to cater to the fast-growing Islamic financial service sector in Australia. Hence our research questions for this paper are:

i. How is the Islamic service sector regulated in Australia?; and,
ii. Given that the Islamic finance market is still premature in Australia, how should it be better regulated?

This paper aims to understand and develop a regulatory reform framework for Islamic finance sector in Australia. Acknowledging the heterogeneity of Islamic finance under different jurisdictions, this study is only scoped down to the analysis of development of Islamic finance in Australia. The case study adopts a problem-oriented method, with a particular interest in identifying the major regulatory challenges facing Islamic finance in Australia and in developing solutions to these problems.

The paper proceeds as follows, the rest of the section summarised the global development of the Islamic finance, identified opportunities for Islamic finance in Australia, reviewed Australian governments' supportive policies toward the Islamic finance and evaluates the regulation of the financial service providers in Australia. Section 2 reported the findings from the case study, including the shifting of the governance paradigm from the shareholder hegemony to a stakeholder interest, as well as that of the regulation from the 'one size fits all' model to a responsive regulation framework. Section 3 discussed the application of the proposed policy option based on two examples, corporate governance and stamp duty. Section 4 concluded with acknowledgement of the limitation of this study, recommendations and proposition of future research direction.

1.1. Global development of Islamic finance

Islamic finance is one of the fastest growing segments of the global financial services industry. Shariah-compliant financial assets have been growing at over 10 per cent per annum over the past 10 years. Measured by Shariah-compliant assets of financial institutions, the global Islamic finance industry is estimated at US$822 billion in 2009 (Austrade 2010).

Austrade (2010) identifying the following factors pertinent to the growth mentioned thereof:

- petrodollar liquidity: Foreign investment plays an important role for petrodollar investors, whose domestic economies and financial
- systems are too small to absorb all capital from oil export revenues. This presents significant opportunities for the Islamic banking and finance industry. Petrodollar liquidity is expected to remain high over the long term due to the finite supply of oil reserves;
- Muslim population: Relatively rapid Muslim population growth worldwide and rising living standards will see increased demand for Islamic finance;
- low penetration levels: In spite of growth in the Islamic banking and finance industry, there remains a lack of depth across asset classes and products, signifying untapped potential. There is considerable scope for further development of Islamic banking and finance in countries such as Indonesia, India and Pakistan, which have the largest Muslim populations in the world; and
- ethical character and financial stability of Islamic financial products: Islamic financial products have an ethical focus (notably excluding investment in alcohol and gambling) and a risk profile that will also appeal to a wider ethical investor pool.

Currently, the Middle East and South East Asia are the primary locations for Islamic capital. In particular, the United Arab Emirates, Bahrain and Malaysia are seen as the main centres of Islamic finance, with significant activity also taking place in the United Kingdom and more recently in Europe, Africa and Indonesia.

The demand for Islamic finance has not been matched by supply despite the rapid growth in the sector in recent years. An increase in supply is necessary to meet current and expected demand.

1.2. Opportunities of Islamic finance in Australia

Islamic finance has considerable potential to become an important element in Australia's aspirations to be a global financial services centre in the region. It has the potential to facilitate further innovation and competition in the wholesale and retail banking sectors and to support the Australian Government's commitment towards credit market diversification.

Australia's growing trade linkages with Asia reflect the demand for Australian commodities from developing countries such as China and India. Of the top 10 trading partners, eight are in the Asia Pacific Region with China and Japan being the country's top two-way trading partners.

Continued growth in major Asian economies will result in a need to develop resources-related services and infrastructure, which are ideal assets for some forms of Islamic financing, such as Sukuk, Mudaraba, Murabaha and Ijarah. Australia is well positioned to structure and offer such instruments as part of financing packages for resources-related development.

Australia's Muslim population of 365,000 (1.7 per cent of the total population), exceeds the combined Muslim population of Hong Kong and Japan and is more than half of that of Singapore. Australia's political stability and geographic position, especially its proximity to the large Muslim populations of the Asia Pacific where 62 per cent or 972.5 million of the world total Muslim population resides, present an important base to service this fast growing sector in the global financial services market (ABS 2010).

Australia's attractiveness as a financial centre is supported by a sizeable domestic economy and financial market. The nation has the fourth largest economy in the Asia Pacific (after Japan, China and India). Australia's finance and insurance industries generate around 8.1 per cent or A$82 billion of real gross value added (Austrade 2010).

Australia is well placed to take advantage of the Islamic finance opportunity, with widely recognised strengths in retail and commercial banking and experience in infrastructure, property, resources and agricultural financing.

Specific opportunities for Australia include:
- attracting foreign full-fledged Islamic banks and conventional bank Islamic windows to establish operations in Australia;
- attracting investment in Australian assets and businesses from overseas Shariah investors and tapping into new funding sources through Sukuk and other securitised issues;

- Australian-based banks providing from Australia a range of Shariah-compliant investment and financing products and services to Islamic banks, corporations, institutions and high net worth individuals in the Asia Pacific and the Gulf regions;
- fund managers establishing Shariah-compliant funds for Asian and Gulf institutional and high net worth individual investors;
- local exchanges providing an Islamic listings platform for domestic and international issuers of Shariah-compliant instruments;
- provision by Australian-based financial institutions of Shariah-compliant/ethical financial services and products to Muslim and non-Muslim customers in Australia;
- Australian-headquartered banks and insurance companies exporting Islamic financial services through windows as they grow their operations into Asia; and
- Australian-based financial firms, professional services providers and educational institutions exporting their services into Asia and the Gulf.

1.3. Australian governments' supportive policies toward Islamic finance

Australian Federal and state governments recognise that growth of Islamic finance in Australia requires supportive government policies. It is important that there is (NSW Government 2009):

- a level taxation, legal and regulatory playing field for Islamic and non-Islamic finance. Taxation must be responsive and enabling but non-preferential;
- strong promotion and facilitation through government investment attraction and export promotion agencies;
- government engagement with the private sector in achieving Islamic finance objectives, identifying impediments to, and opportunities for growth;
- a focus on deepening Islamic finance skills – education, training, attainment of relevant qualifications – and on access to appropriate Shariah scholars; and
- growth in Islamic finance professional services providers.

1.4. Regulatory and governance framework of the financial service sector in Australia

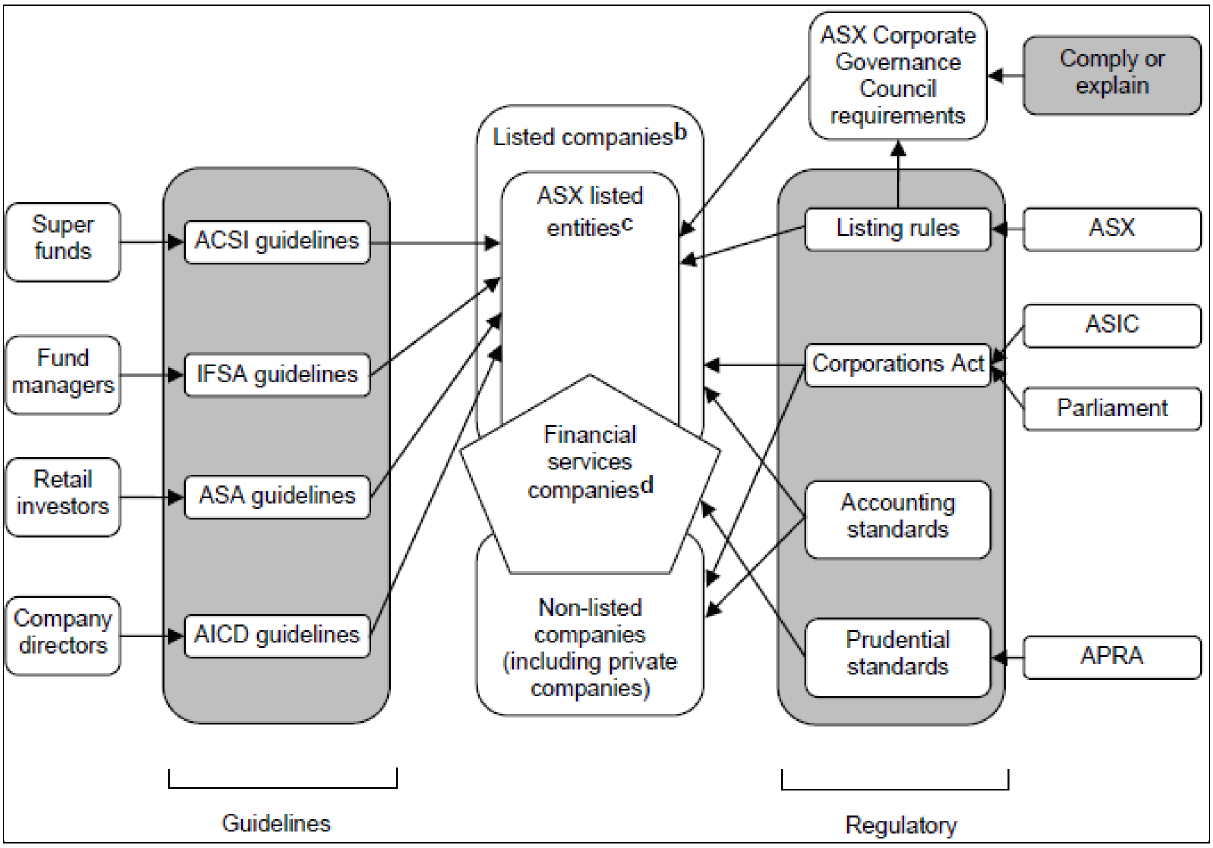
The government regulation and corporate governance of the financial service providers are intertwined in the Australian context. Government regulation can be defined as (1) a principle, rule or law designed to control or govern conduct of people and business; (2) the way a particular regulation is implemented in practice. This definition incorporates not only legislation and formal regulation, but also quasi-regulation, for example, a code of conduct or advisory instruments (Banks 2006).

Corporate governance can be defined as:

> *The system of regulating and overseeing corporate conduct and of balancing the interests of all internal stakeholders and other parties (external stakeholders, governments and local communities …) who can be affected by the corporation's conduct, in order to ensure responsible behaviour by corporations and to achieve the maximum level of efficiency and profitability for a corporation (Du Plessis, Bagaric et al. 2010, p. 10).*

Thus corporate governance is not simply a product of government regulation. Companies have inherent incentives to establish governance procedures to demonstrate their bona fides to investors, in order to attract capital. Executives also have incentives to deliver good performance to maintain their professional reputations. But rules can reinforce such incentives and diminish the risk of a loss of confidence in a market resulting from poor behaviour of a few.

However, as it is evident in Figure 1, the religious component of the governance of the Islamic financial service companies has been largely ignored. The identified gap signals two questions: 1. Does the 'one size fits all' model work? And, 2. If not, what are the alternatives? Answers to these two questions will be provided in the following sections.



Note: Acronyms are as follows — a. ACSI: Australian Council of Super Investors; AICD: Australian Institute of Company Directors; APRA: Australian Prudential Regulation Authority; ASA: Australian Shareholders' Association; ASIC: Australian Securities and Investments Commission; ASX: Australian Securities Exchange; IFSA: Investment and Financial Services Association. b. Listed public companies will predominantly be ASX-listed entities. Exceptions are companies listed on other Australian stock exchanges, such as the National Stock Exchange of Australia and the Bendigo Stock Exchange. c. Most ASX listed entities would be listed public companies in the context of the Corporations Act. Exceptions include some listed trusts and companies incorporated outside Australia. d. Some APRA-regulated banks and insurance companies would be ASX-listed entities. However many, including credit unions, building and friendly societies, and superannuation funds are not ASX listed.

Figure 1: The regulatory and governance framework of the financial service sector in Australia[a]

2. Findings and Discussion

Legislation for the regulation of financial services is developed by the Commonwealth. The Australian Securities and Investments Commission (ASIC) implements and administers the law. Many financial services are also regulated by the Australian Prudential Regulation Authority (APRA).

ASIC administers the Corporations Act 2001, which requires people who carry on a business of providing financial services to hold an Australian Financial Services (AFS) licence (unless they are covered by an exemption or are authorised as a representative of an AFS licence holder).

Islamic financial products are regulated in the same way as any other financial product in Australia. Regulation is generally in terms of product approvals, disclosure and accounting standards, standards for intermediaries (i.e. stockbrokers), as well as regulation of non-banking entities such as collective investment schemes. Regulation of the finance sector is designed to maximise market efficiency, with minimal regulatory intervention to protect investors.

In Australia, the regulators treat Islamic financial services providers as a normal financial company; hence there are no shariah law-binding requirements (Figure 1). The complexity of the regulatory compliance requirements is only contingent on whether the company is listed on the stock exchange. Obviously, the regulators have yet to be educated about the fundamentals of Shariah law and Islamic finance.

Regulation to protect investors is limited to conduct and disclosure requirements imposed on AFS licence holders. Licensees authorised to provide advice about financial products are required to meet certain minim um legislative standards when advising clients. The National Consumer Credit Protection Act 2009 (Cth) is designed to provide additional safeguards and protections for consumers to the process of obtaining credit in Australia. This covers all types of consumer credit from credit cards to mortgages.

APRA is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry. In essence, APRA ensures that regulated entities honour the financial promises made to beneficiaries. It creates and administers an extensive set of prudential standards to give regulated entities extensive guidance in matters such as risk management and minimum capital levels. Recent decades in Australia has witnessed the shift of the regulatory reform from 'one-size fits all' model to a responsive regulatory paradigm. At the same time, the governance reform extended the shareholder hegemony model to the stakeholder model, which takes into account not only the shareholders, but also other stakeholders such as employees, customers, investors, community, suppliers and industry associations.

There is no single or enduring best-practice model for corporate governance: different approaches and combinations of approaches can promote alignment and trust, while company structures and market expectations change over time. Indeed, the diversity of companies makes flexible governance arrangements highly desirable — one size is unlikely to fit all. In addition, regulations designed to promote alignment and accountability, if they are excessively prescriptive, have the potential to impede the ability of managers to manage. To accommodate diversity and to balance objectives, Australia's corporate governance framework has accordingly evolved over time, combining ‘black letter’ law with ‘soft’ law requirements, as well as other industry-based guidance.

Moreover, a properly designed regulatory regime catering to the needs of the Islamic financial service providers must imbed the Shariah principles in the regulation design and implementation, while taking into account the distinct features of the Islamic institutions. Hence, governance mechanisms related to the Islamic financial service companies should incorporate the internal governance and external governance (Gillan 2006). Internal governance may include the Shariah board, board of directors, sub-committees and internal control mechanisms such as internal audits; while external governance may include market control and regulation.

Of relevance to the internal governance of Islamic financial institutions are two prominent theories, one is the dominant Agency Theory and the other the Stakeholder Theory. While the regulatory options, with a particular interest in design and enforcement here, may include coercion via ‘black letter’ law (also known as the public ordering), self-regulation via ‘soft’ law (also known as private ordering) and internal governance, as well as the hybrid of the two options. These two paradigm shifts are discussed as follows.

2.1. Corporate governance: shareholders or stakeholders?

The Agency Theory originated from Jensen and Mackling (1976) who contends that firms are the nexus of the contracts. The essence of the agency problem is the separation of management and finance. Due to the incompleteness of contracts, managers withhold control over the residual control rights, which are not foreseeable ex ante. Thus, corporate governance concerns with managers putting constraints on themselves, or investors putting constraints on managers, so that the misallocation problem can be reduced and investors will be induced to provide more funds.

Freeman’s Stakeholder Theory intends to address three problems: (1) the problem of value creation and trade; (2) the problem of the ethics of capitalism; and (3) the problem of a managerial mindset (Freeman et al. 2010, p. 29). Freeman et al. (2010) holds that: (1) the basic objective of a firm is to create value for stakeholders; (2) business is a set of relationships among groups which have a stake in the business activities; (3) business is about how customers, suppliers, employees, financiers (such as stockholders, bondholders, banks, or investors), communities, and managers interact and create value. To understand a business is to know how these relationships work. In this context, the executive’s or entrepreneur’s job is to manage and shape these relationships. Hence, stakeholders are defined as customers, suppliers, employees, investors, communities, and managers who interact and create value for firms.

Li et al. (2012) find that Profit-sharing Investment Accounts (PSIAs) holders may suffer from lack of protection due to information asymmetry. Consequently, PSIAs-holders may expect a high risk premium by increasing the cost of capital, or may withdraw their deposit. Hence, corporate governance in Islamic financial service institutions should aim at protecting investors' rights as well, which warrants the appropriateness of the adoption of stakeholder theory.

2.2 Regulatory theories: public ordering vs. private ordering

Given that the Agency Theory's omnipotent focus is on developing corporate governance mechanisms to solve the distributed shareholding problem in large corporations, it failed to consider the other stakeholders, particularly the Islamic beliefs. From a legal perspective, governance requirements deserve scrutiny on balancing the expectation of the Islamic financial service providers and that of the regulators.

McCahery and Vermeulen (2008) analysed corporate governance for non-listed companies and provides a detailed explanation of public ordering and private ordering. Public ordering is also called hard law, which cover the legal requirements, rules and regulations. Private Ordering is the process of setting up of social norms by parties involved in the regulated activity, and not by the State. Private Ordering aims to achieve public goals, such as efficiency, enhancing the market, and protecting rights. Private Ordering may include customised contracts and private arrangements amongst different stakeholders.

Incorporating self-regulation of the international regulatory requirements into the regulatory model (Figure 2), Islamic Financial Service providers who are members of the International Financial Service Board (IFSB) has to be abide by the IFSB guidelines and The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) guidelines, as well as other industry/product specific regulatory guidelines whenever applicable, which are either 'rule-based' or 'principle-based' and requires 'comply or explain' compliance requirements. If a member organisation fails to comply with the guidelines, it has to explain why the regulatory requirements had not been met (or 'if not, why not').

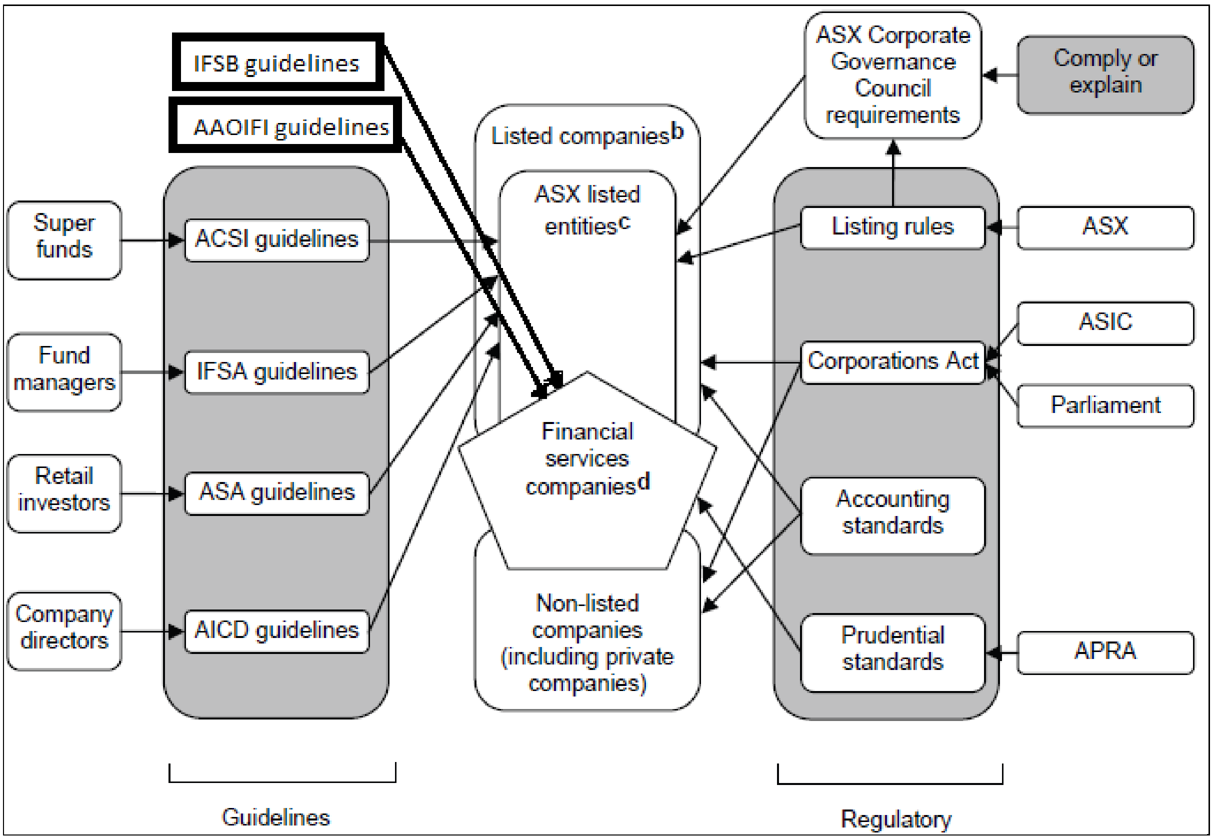


Figure 2: Regulations of Islamic Financial Institutions in Australia

2.3. Developing a responsive regulatory framework for Islamic finance sector in Australia

Given the complexity of the corporate governance issue in Islamic finance companies and the heterogeneity of Islamic companies at large, the hybrid approach which combines the public and private orderings, seems to be a better option. Specifically, regulators, Islamic finance companies, and the other stakeholders should make joint effects to solve governance problems in the operation of small corporations, detailed proposal will be presented as responsive regulation below.

Since the influential work of the Chicago school of economics in the 1960s and 70s, economists, lawyers and social scientists have been interested in government regulation and its efficacy (Stigler 1961, 1971). The international literature has been concerned with regulation that is both 'effective' and 'responsive' in order to ensure that government is attuned to differing motivations of regulated actors (Ayres and Braithwaite 1993). Much of the literature has argued for less government intervention and for the need to formulate efficient legal rules to foster an optimum environment in which small corporations can flourish.

The best regulatory strategy depends on context, regulatory culture, and history (Ayres and Braithwaite 1993, p.5). Cultural, social, economic and political imperatives are vital. In Australia, for example, the Hawke federal government introduced the notion of regulatory impact statements, and such statements are now commonplace in other contexts, such as the environment: efficacious regulation should speak to the diverse objectives of regulated firms, industry associations, and individuals within them (Ayres and Braithwaite 1993).

The responsive regulatory system model builds on the McCathery and Vermeulen's three pillars of regulation on governance of non-listed small businesses (2008 p. 12) and Ayres and Braithwaite's responsive regulatory model (1993, p. 21). It advocates that the regulation of small corporations should not be 'one size fits all', but responsive to the contextual contingencies and responsive to the compliance responses from small corporations. Though the responsive regulatory pyramid was first developed to address the regulatory compliance issues by Ayres and Braithwaite, it offers an excellent opportunity to present the self-regulated corporate governance and coerced regulation in a continuum.

Proper corporate governance mechanisms may serve as a self-regulatory mechanism, which requires the least regulatory cost, sitting at the bottom of the 'regulatory pyramid' (Ayres and Braithwaite 1993). While government regulation serves as enforcement or coercion, and demands a significant amount of resource and efforts to comply with, sits at the top of the pyramid. The other private arrangements in the form of customised contracts, optional guidelines, good practices, and corporate governance system serve as self-regulatory mechanisms. The hybrid may involve interactions between the external environment and internal environment of the Islamic finance companies, including regulation of corporate governance, optional guidelines, CSR, social networks, public-private partnership. Such requirements are responsive to the size of the Islamic finance companies, the development stage on the business life cycle, the industry that Islamic finance company operate and business connections with the government and government agencies. Responsive regulatory system has a strong focus on generating incentives for regulatory compliance (Braithwaite 2006).

Given that the responsive regulatory framework has proven to be effective by a number of applications in regulatory design in Australia and overseas, for example, the Australian Taxation Office, it should replace the current 'one size fits all' model. It has to be implemented by joining the efforts of multiple parties, including the governments and their agencies, Islamic finance companies, industry associations and the community.

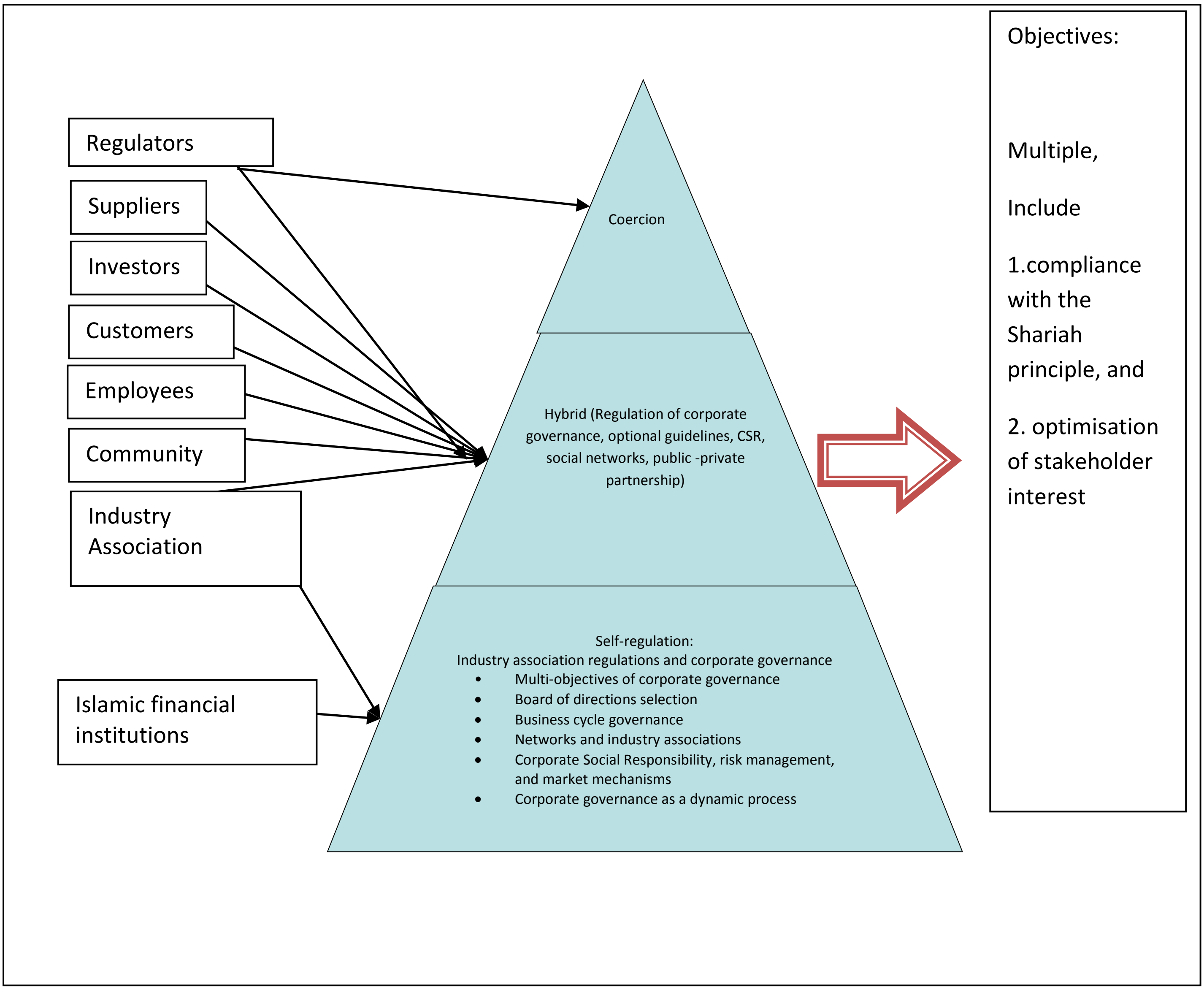


Figure 3: Developing a responsive regulatory model for Islamic finance service companies in Australia

Different from the previous two models (as presented in Figure 1 and Figure 2), the proposed Responsive regulatory framework for Islamic finance companies incorporates the public ordering (through legislation and coercion), private ordering (through private arrangements) and the hybrid (through reactions to the regulation responsive of the contingencies such as firm size, development stage, and industry structure). One may see regulation as the external governance of corporate governance (Gillan 2006). Similarly, one can also view corporate governance as a special form of regulation - self-regulation. The proposed model has two ultimate objectives, one is to abide by the Shariah law, and the other is about optimising the stakeholders' interests.

Comparing to the 'coercion only' regulatory model and the 'self-regulation only' model (or lass faire), the 'responsive' is able to engage the stakeholders at different stages hence may significantly reduce the monitoring and reporting costs. The responsive regulatory model suits the Islamic financial service providers' need in both religious and financial terms and they have the autonomy to select the optimal combinations of the SSB or market mechanisms for the certification of their products and transactions. The timely evidence-based evaluation system ensures the feedback to be incorporated in the planning and reforms, hence increasing the responsibility and sustainability of the Islamic financial institutions. Thus the responsive regulatory option outweighs the alternatives.

The responsive regulatory framework can be operationalised as a 'seven-stage model' (Figure 4). The seven stages include

Stage 1: Identifying the governance and regulation problem
Stage 2: Identify the objectives of governance and regulation
Stage 3: Establish the baseline of regulation as per the 'public ordering'
Stage 4: Develop the self-regulatory mechanisms
Stage 5: Identifying the hybrid mechanisms
Stage 6: Establish a code of conduct & transfer the good practice into policies & procedures
Stage 7: Develop an evidence-based evaluation system to monitor the progress and provide feedback to Stage 1.

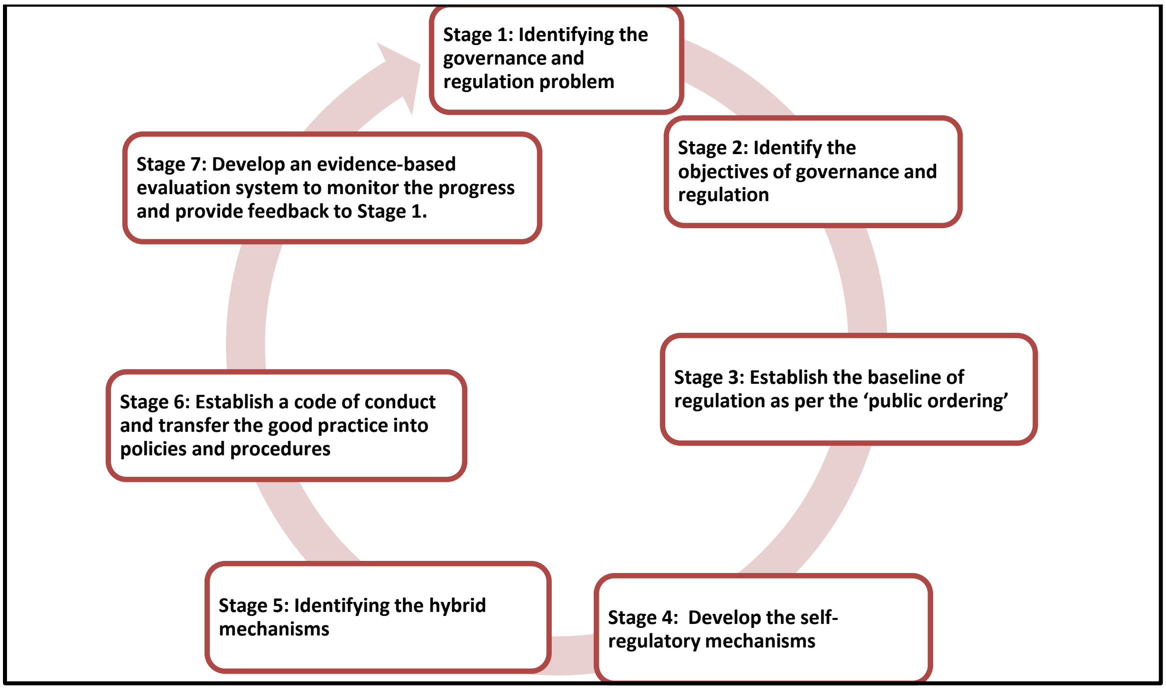


Figure 4: A Seven-Stage Responsive Regulatory Model for Islamic Financial Institutions in Australia

3. Application of the proposed model: corporate governance of the Shariah Supervisory Board (SSB)

This section applied the seven-stage model (Figure 4) on the corporate governance of the SSB.

Stage 1: Identifying the governance and regulation problem

The SSB is a binding requirement in the Shariah Law as the 'public offering' which has the coercion power. Hence, a SSB has to be presented in order to meet the religious requirements. However, the SSB becomes a corporate governance issue due to that set rules are yet to be establishment on the selection, composition, assessment and dismissal of the SSB members.

While some international jurisdictions have established regulatory requirements for the appointment of Shariah advisory bodies, there is no standardised requirement across jurisdictions in respect of the eligibility and qualification of Shariah advisors (IOSC 2004). Should the SSB members be elected or appointed?

The stakeholders in this problem include the regulators from IFSB and AAOIFI, national and local level regulators, investors, directors of the SSB and the board of directors.

Stage 2: Identify the objectives of governance and regulation
The objectives of the introduction the SSB is to bind with the Shariah compliance as well as improving the Stakeholders' interests.

The credibility of the Islamic finance sector is a paramount concern to the majority of stakeholders. The importance of trust in the Islamic capital market was repeatedly raised by stakeholders and reputation is seen to be an essential component of establishing Islamic businesses anywhere in the world.

Shariah is open to interpretation and scholars frequently hold varying views on key Shariah issues. Islamic jurisdiction is not bound by precedent, and opinions may deviate from previous decisions made by other Shariah scholars. This lack of standardisation may become a cause for concern. It may result in different transactions being interpreted differently, leading to consumer uncertainty regarding Islamic finance products.

National and state regulations often necessitate a compromise of Shariah compliance in Australia – for example, the requirement to declare the level of interest on a mortgage contract, which is not appropriate for Islamic mortgages. However, in instances like these where there is no legal alternative Shariah scholars allow a degree of flexibility in the application of Shariah law. This flexibility is also not uniformly applied.

The pool of Shariah scholars from whom to draw advice upon financial products is relatively small in Australia. Notably, many of the wholesale providers currently seek compliance endorsement overseas. Other jurisdictions that have a mature Islamic capital market, such as Malaysia and Dubai, regulate Shariah compliance.

The lack of industry standards or regulation of Shariah compliance gives rise to three possible problems:

- Allowing potential rogue operators to flourish and damage the reputation of the Islamic finance sector in Australia;
- The compromise of consumer confidence in cases where the interpretation of Shariah compliance does not meet with common interpretation, or where the Shariah ruling is not disclosed;
- The decline in international investment if Shariah compliance does not meet international standards.

Stage 3: Establish the baseline of regulation as per the 'public ordering'
The establishment of the SSB requires that the directors to be elected have to possess sufficient Shariah knowledge and should exercise Shariah compliance checks as an internal auditing mechanism. Other requirements may be pertinent to the regulatory requirements for financial service companies in Australia.

Stage 4: Develop the self-regulatory mechanisms
Financial institutions have their own in-house independent Shariah advisory bodies that screen and endorse their Islamic products. The Shariah certification process is generally undertaken by private sector in-house Shariah advisory bodies, driven by private sector-led initiatives, and is not mandated by any specific regulatory or policy requirement. The SSB may have to work with the Shariah advisory bodies in order to exercise a final check.

An industry-led 'Shariah compliance board' was proposed as a means by which to regulate Shariah compliance and secure the market nationally. It may be the case that the current Islamic market in Australia is too small to warrant introducing additional regulation at this time. Alternatively, the industry could develop its own set of voluntary standards. There is benefit to developing an industry voluntary code of conduct for Shariah boards as an industry development exercise. A voluntary code would provide additional certainty for investors as to the Shariah compliant nature of a product (i.e. brand integrity) and maintain industry standards at an international level. This approach would have the greatest benefits if adopted nationally.

Industry codes of practice have been developed by a number of industry associations in the financial services sector. They range in content from general statements of principle about how the financial services industry operates, to listing specific industry practices which are guaranteed by the code.

Stage 5: Identifying the hybrid mechanisms
Appropriate Shariah certification is issued for all Islamic capital market products and services e.g. in Malaysia, Indonesia, Sudan and Pakistan. The Shariah certification process is undertaken at the regulator's level, under the guidance of their own Shariah advisory bodies to formally advise on issues of Islamic capital market products and services. Shariah compliance issues are taken into consideration in the regulator's functions such as product approval, eligibility criteria for intermediaries, reporting requirements of regulated entities, and enforcement of regulatory requirements.

Stage 6: Establish a code of conduct and transfer the good practice into policies and procedures
Existing codes either contain minimum standards or standards which are aimed at best practice, some examples include the Finance Brokers Association of Australia's Code of Practice & Disputes Resolution; and Financial Services Council's Code of Conduct and Code of Ethics.

In recognition of the strong stakeholder support the national and local level regulators should facilitate stakeholder development of a voluntary code of conduct for Shariah boards in order to promote industry development.

The code of conduct, as well as the procedure of SSB director selection, evaluation, compensation and removal and other good practices as well as lessons learned can be codified into policies and procedures to govern the operation of the Islamic financial institutions.

Stage 7: Develop an evidence-based evaluation system to monitor the progress and provide feedback to Stage 1.

Evidence-based system can be introduced to evaluate the performance of the proposed responsive regulatory system. Any feedbacks can be incorporated into Stage 1 for another round of reform.

As mentioned at the beginning of the case, Abdul and David had been challenged by the perplex but yet to be developed regulatory framework for Islamic finance companies in Australia. The abovementioned seven-stage model offers a guidebook for them to analyse any governance and/or regulation problems at any stage of the development of their Islamic financing businesses.

4. Conclusion, limitations and future work

After investigating the potential development opportunities of Islamic finance in Australia, it was found that their regulatory requirements have been largely ignored. As such, the shadow existence of Islamic finance has been further impeded by the unintended consequences of 'one size fits all' regulatory model. A responsive regulatory model was developed (Figure 3), followed by its seven-stage operational model (Figure 4) to guide application of the proposed responsive regulatory model.

Furthermore, the responsive regulatory model has been applied to the corporate governance of the Shariah Supervisory board. The model, comparing to the extant 'one size fits all' model, it has shown advancement in efficiency, suitability, accountability and sustainability.

Admittedly, this study is subjected to the limitation that it only focused on the Islamic finance in Australia from the macro-level. Hence, future endeavours may be devoted to micro-level analysis, which analyses the regulatory compliance behaviour of each individual Islamic financial service provider in Australia.

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RELATIONSHIP BETWEEN MARKET STRUCTURE AND STABILITY IN THE BANKING INDUSTRY

Abstract

Market concentration and competition are arguably, especially in last decade, one of "hotly debated topic" in banking and financial industry. Their importance is clearly visible on financial stability. Financial stability is important issue because of influence on the real economy and potentially large government costs. Topic importance is obviously seen in bank restructuring and consolidation, peculiarly when global financial crises begun. Explanation of these correlations and multilateral effects are resulted in the existence of numerous theories and many researches in that area. Between policy makers and academics there is still discussion about how bank competition and concentration with regulatory framework, which is given from state, influence on financial stability. This paper reviews the importance of market structure for financial stability according to competition policy, regulatory environment, "too-big-to-fail-institutions", etc. Therefore, this paper exhaustively gives concentration and competition measures as well as causes for further investigation of financial stability. All mentioned are "conditio sine qua non" for the development of the banking industry.

Keywords

banking industry, bank concentration, bank competition, financial stability

1. Introduction

During the last decades, there is no banking industry in the world, which has not experienced a transition period as a consequence of deregulation, improvement in information technology, expansive globalization and changes in economic environment. Impacts of that changes were clearly observable in number of banks and bank branches, used technologies, quality of human resources and the scope of banking operations as well as regulatory frame and institutional structure of the banking industry. According to mentioned changes, market concentration and competition with repercussions on financial stability is one of most attractive theme for economic researchers and practioners especially when global financial crises in 2007 begun.

The shock of the global financial crises has scientifics wondering about the future of banking industry. Given the wave of consolidation witnessed over the past decades and the recent pressure to limit and penalize the size of banks tagged "too-big-to-fail", it has never been more important than for resurrection of the age-old structure-conduct-performance. All that

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reforms aimed to enhance both the productivity and efficiency and the degree of competition of banking markets as a way of improving overall operational performance of the financial services sector specially because problems in the functioning of the banking sector can have an impact on macroeconomic (inflation and capital markets) and microeconomic effects (functioning of the payment system and development of financial markets and brokerage functions) what in overall implies on financial stability at all. Consequences of vulnerable periods are affected on all level of bank business especially on capital adequacy. Sufficient capital adequacy has allowed banks to sustain their growth and to feel practically no or little bit pressure from regulators on capital adequacy what was obvious on satisfaction of Basel III requirements. Yet the gap between banks has also been disappearing, as banks have boosted their capital positions significantly following the financial crisis. So this effects dominantly on financial stability not even on banks thus overall financial system and economy at all.

All mentioned provides an ambiguous answer to the question how bank competition, bank concentration and financial stability are related. On the one hand competition reduces the market power of banks, which reduces the discounted value of the future bank profits. This enhances the incentives for banks to take more risk, because the opportunity costs of going bankrupt are lower. On the other hand, market power in the loan market allows banks to charge higher interest rates what increases adverse selection and moral hazard. Main consecuences of that is increases in the probability of banks failure what implies on financial stability and economy in whole. Many theoretical papers have attempted to explain the ambiguous consequences of concentration and competition on access to credit, cost and quality of financial services, innovation, the stability of financial systems, and thus economic development. It is well known that banking sector have to be competitive and efficient, but same importance has stability.

The paper is organized as follows. After introduction, Section 2 presents theoretical background of literature on concentration in the banking sector, and their main measures. Section 3 gives overview and measures of competition in the banking industry. Analysis of banking industries in selected countries is investigated in Section 4. Section 5 discusses on main characteristics and relations between market concentration and competition as well as financiral stability. At the end, Section 6 concludes the article.

2. Significance of concentration in the banking industry

Most commonly market structure is deferred to the degree of market concentration, i.e. the number of companies and their market shares. Indicators of market concentration seek to identify how the product is allocated between the different companies. In accordance with the neoclassical theory, the greater the number of firms in the market the more likely it is that there are smaller differences in company size and a higher degree of competitiveness (Škuflić, Galetić and Gregurić, 2011). For investigation of behaviour of the banking market we can use structural and non-structural approaches. Structural approaches are mainly based on the traditional industrial organization theory which focuses on the structure-conduct performance (SCP) paradigm and on the efficient structure paradigm. Literature based on structural approaches has investigated how the market concentration weakens the market competition by fostering collusive behaviour among firms. Conversely, non-structural approaches assume that factors other than market structure and concentration may affect competitive behaviour, such as entry/exit barriers and the general contestability of the market.

The analysis of market concentration in the banking sector typically branches off into two directions in the literature. One direction is a structural approach based on the so-called SCP paradigm, the hypothesis on market efficiency and a range of other formal approaches in the theory of industrial organization. The SCP paradigm analyses whether a higher level of market power concentration leads to tougher competition between large banks and better overall market performance for clients (primarily through lower interest rates). This paradigm highlights the theoretical relationship between the structure (concentration levels), behaviour (competition) and performance (for example, profitability of banks). The SCP theory predicts that profits and output prices would be higher the greater the level of concentration in a given market. This is due to the greater ease of collusion in a more concentrated market. When applied to the banking industry it predicts that profits, interest rates on each type of loan and services charges would be higher in a more concentrated market. On the other hand deposit rates offered would vary inversely with concentration (Gilbert 1984). Hall and Tideman (1967) argue that a good concentration index should satisfy a number of key criteria:

1. Concentration should be a one dimensional measure;
2. Concentration in an industry should be independent of the size of that industry;
3. Concentration should increase if the market share of any firm is increased at the expense of a smaller firm;
4. If each firm in a given industry is divided into two firms of equal size then the concentration index should be reduced by one-half;
5. When an industry is divided into N equal sized firms, a measure of competition should be a decreasing function of N;
6. A concentration measure should have a range of zero to one (while this property is not strictly necessary, it makes the measure easier to interpret).

Non-structural approaches have been developed in the context of the new empirical industrial organization (NEIO) literature. This study is based on structural approaches expecting to uncover the advantage of enhancing banks operational efficiency against bank concentration. The next section presents basic arguments of structure conduct performance hypothesis (SCH) and efficient structure hypothesis (ESH), application in banking industry and their findings. The SCP framework has been widely used in the literature to examine market structures. However, it does not account for other factors which influence firms' profitability and concentrations. Further, SCP studies ignore the long-run equilibrium in the market. Therefore, the evidence from market concentration studies may be insufficient to support firm conclusions about the relationship between market behaviour and competition (Seelanatha, 2010). Market shares are the basis for determining concentration indicators, which are briefly described below.

If there are *n* companies in some industry whose aggregate production is *Q,* where q_i is the amount of production of each firm (i = 1,2,3 ... n), the following applies:

$$Q = \sum_{i=1}^{n} q_i \qquad (2.1.)$$

The share of production of a company is obtained as

$$s_i = \frac{q_i}{Q} \qquad (2.2.)$$

Concentration index is calculated as

$$S_i = 100 \cdot s_i = 100 \cdot \frac{q_i}{Q} \qquad (2.3.)$$

Concentration index varies between *0*, in case of a perfectly competitive market, and *100* in the case of monopoly ($0 \leq S_i \leq 100$). It is also the proportion of enterprises in the entire market, and thus this indicator is sometimes referred to as market share. This indicator is most often applied in a form of **concentration ratio,** which shows the percentage (share) of the four largest firms, and is calculated as:

$$CR_4 = \sum_{i=1}^{4} S_i \qquad (2.4.)$$

The drawback of this indicator is that it only takes into account the share of the four largest firms, and will be the same for the industry where the top four companies each have a 20% share and the industry in which out of the four largest companies, one company has 65%, while the other three have 5% share, although the degree of concentration of these markets is not equal. This indicator linearly measures the proportion of each company, and makes no distinction between different sizes of firms. Likewise, criticism related to this indicator are reduced to an arbitrary choice of the number of enterprises, where according to some economists the index takes the four largest firms, according to others five, seven or eight. Uneven choice of the number of businesses will certainly give different information on concentration in particular industries.

Herfindahl-Hirschman index is another indicator of concentration, and is calculated as the sum of squared market shares according to the formula:

$$HHI = \sum_{i=1}^{n} S_i^2 \qquad (2.5.)$$

Comparing to concentration index, this is a better indicator because it gives greater weight to bigger companies and smaller weight to smaller companies, so the picture of concentration of an industry is more realistic.

Although the absolute level of HHI can provide a first insight into the pressures on the market after the implementation of concentration, the change in index (called the "delta") is a useful surrogate measure of changes in concentration occurred as a direct result of concentration. In the European Regulation on the control of concentrations 139/2004 HHI is mentioned as a measure for concentration, where below a certain level there is no negative effects of mergers and strengthening of concentration. The market with HHI below 1000 is considered non-concentrated, while for the markets which have HHI between 1000 and

2000 (delta is less than 150), there is no concern that there will be adverse effects on competition (Škuflić, Galetić and Gregurić, 2011).

Tideman-Hall concentration index (HTI), in contrast to Herfindahl-Hirschman index, emphasizes the importance of the absolute number of companies when calculating concentration. Specifically, HHI is also dependent on the relative number of enterprises, and is growing very rapidly only with a change in market share, but not with the entry of new small firms in the industry (Foldvary, 2011). The advantage of the inclusion of the absolute number of firms in the calculation is that this number can express the entry of a new company in the industry, and it is assumed that the market entry is easier if there are already a number of companies operating in that market. HTI is calculated using the formula:

$$HTI = \frac{1}{2\sum_{i=1}^{n} i \cdot s_i - 1} \qquad (2.6.)$$

where the market share of each company is multiplied with the corresponding rank. HTI value ranges from *1/n* to *1*, where values close to *0* indicate perfect competition, while the other extreme, a monopoly, takes the value *1* (Foldvary, 2006).

Rosenbluth index (RI) is very similar in shape to Hall-Tideman index. They differ only by ranking companies. Specifically, the Rosenbluth index gives smaller companies higher rank, so it has more influence on the indicator itself than on the large firm. It is calculated using the formula:

$$RI = \frac{1}{2\sum_{j=1}^{n} j \cdot s_j - 1} \qquad (2.7.)$$

The assumption is that companies are sorted from the smallest to largest, in contrast to the previous indicator. From this it follows that RI gives great importance to small businesses. Similar to HHI, the value ranges from *1/n* and *1*, where *1* denotes a monopoly on the market, and value close to *0* indicates a perfectly competitive market (Moschandreas, 2000).

Comprehensive Concentration Index - CCI was designed as a combination of two types of indicators, and at the same time it shows the relative dispersion between firms, but also the absolute number of firms. It is calculated by adding the market share of the largest company to the aggregate index that covers the reminder of firms in the industry.
The formula for calculating is the following:

$$CCI = s_1 + \sum_{i=1}^{n} s_i^2 (2 - s_i) * 100 \qquad (2.8.)$$

The share of the largest companies is set aside from the calculation, but is later on added to the sum which indicates concentration of the rest of the industry. CCI index ranges from *0* to *100*, and gives a value of *0* for perfect competition, and *100* for monopoly (Moschandreas, 2000).

Hause index (H) is an indicator of concentration dependent on the parameter which indicates the degree of collusion or agreement between the enterprises. In actual circumstances, it is difficult to prove that the companies secretly collaborate for illicit goals, but it is still necessary to choose several parameters in order to cover this case as well. The index is calculated using the formula:

$$H = \sum_{i=1}^{n} s_i^{2-\left(s_i\left(HHI - s_i^2\right)\right)^{\alpha}} \qquad (2.9.)$$

where the parameter α indicates the degree of collusion between the companies. Parameter values are inversely related to the degree of collusion, so the smallest parameter *α =0.25* indicates the industry with high degree of tacit bargaining. The index H is equal to *0* for perfect competition, while in the case of monopoly it is equal to *1*. An important implication of involving collusion in the calculation is that in the case of tacit cooperation between firms, a new firm entering the market does not result in a significant increase in competition in the market.

Hannah and Key (1977) in their book have suggested another indicator of concentration which is very similar to HHI, but with a difference in the weights assigned to large firms.

The formula for calculating is the following:

$$HKI = \left(\sum_{i=1}^{n} s_i^{\alpha}\right)^{\frac{1}{1-\alpha}}, \qquad \alpha > 0, a \neq 1 \qquad (2.10.)$$

where a change of the parameter α denotes various levels of criteria which are met by the parameter. Where *α> 0* and *α* is different from *1*, it represents an arbitrarily set elasticity parameter. For example, lower values of α emphasize the impact of small businesses, while larger values take more into account the impact of large enterprises on concentration. Most commonly used values for *α* are: *0.005, 0.25, 5* and *10*. As HKI is very sensitive to the determination of parameter α, the index value at low α will move like the number of companies in the market, and will be approximately equal. The result of the HKI index with these parameter values should be taken with caution, as in the case of reducing the number of firms the value of the index will reduce as well, but this does not necessarily mean a decrease in concentration of the market.

Entropy is an inverse measure of concentration and it gives weights to the market shares using the logarithms and then summarizes them (Jacquenim and de Jong, 1977). The formula is:

$$E = \sum_{i=1}^{n} s_i \ln\left(\frac{1}{s_i}\right) \qquad (2.11.)$$

This index takes the value *0* in conditions of monopoly because *ln n = 0*, and *n* is *1* for monopoly. On the other hand, its value in conditions of perfect competition is *ln n.* Here it is possible, instead of the natural logarithm, to use other types of logarithms, but in this case the maximum value that indicator can achieve changes as well.

While highly concentrated markets do not necessarily imply lack of competitive behavior, it is generally agreed that market concentration is one of the most important determinants of competitiveness (Nathan and Neavel, 1989). For banking sector, the relationship between market concentration and competitiveness has been examined in detail for many countries and the results indicated that a high concentration tends to reduce competitiveness (Gilbert, 1984). Sutton (2008) relates market structure to the number and size distribution of firms in a market. However, it is especially the interaction of suppliers and buyers that is important, because this interaction determines the price and quantity sold in a certain market.

3. Review of competition in the banking industry

Economists have not agreed so far about what competitiveness is and this term means different things to different people. Some may consider company competitiveness while others stress national competitiveness. Due to the different levels of definitions and different approaches to the same problem, these scientific debates have inevitably been confused so often. Sometimes competitiveness is associated with rivalry, sometimes with growth, position improvements in the business world, positive and better financial results, etc (Škuflić and Štoković, 2004). From a static view, competition is seen as an important force for firms to operate and produce at the frontier. Those firms operating within the production frontier will do their level best to be located on the frontier while those firms on the frontier will engage in more advanced innovation and technology to remain on the frontier (Berger et al. 1999). Otherwise, restructuring in the banking industry will stimulate those firms operating inefficiently to shift to the frontier. Banks that are not allocating their resources efficiently will perish unless they increase their efficiency by producing more outputs using existing inputs. On the other hand, consolidation also leads to increased concentration, which in turn leads to negative consequences on the consumer's welfare. Therefore, it is important to develop a conceptual framework of the nexus between efficiency and competition in banking.

The intuition behind the market power (MP) theory contains two hypotheses: Under the structure conduct-performance hypothesis (SCP), more concentrated markets lead to increased interest rate spreads as a result of market collusion and other imperfections. Under the relative-market-power hypothesis (RMP), on the other hand, banks with strong market shares may capture market power from product differentiation, which allow them to set advantageous deposit and loan rates. While subtle, these theories differ in the fact that RMP hypothesis suggests that only the largest banks will benefit from increased consolidation, while the SCP hypothesis suggests that all banks will benefit–regardless of market share or size (Skorep, 2011, p. 3).

Typical empirical studies of bank concentration and competition as of the early 1990s found that U.S. banks in more concentrated local markets, as measured by HHI or CRn, charge higher rates on small and medium enterprise loans and pay lower rates on retail deposits (e.g., Berger and Hannan 1989, Hannan 1991), and that their deposit rates are slow to respond to changes in open-market interest rates (e.g., Hannan and Berger 1991, Neumark and Sharpe 1992). Both findings are consistent with the exercise of market power under the SCP hypothesis. However, another common finding in both the banking literature and the general industrial organization literature was that these concentration measures had only very weak relationships with measures of profitability when the market share of the firm was also included in the regression equation. A debate ensued as to whether the results support the exercise of market power versus the alternative efficient structure (ES) hypothesis, in which high concentration endogenously reflects the market share gains of efficient firms (e.g., Smirlock, Gilligan, and Marshall 1984, Rhoades 1985, Smirlock 1985, Shepherd 1986). A more general problem of endogeneity in SCP tests was discussed by Bresnahan (1989) and others in which prices, profitability, and concentration are all jointly endogenous.

Competition can drive banks to reduce their lending costs to borrowers and so increase demand for bank funds to support business and growth. This view has been supported by evidence identified by Angelini et al. (1998) and D'Auria et al. (1999) in their study of Italian banks for their lending costs to Italian corporate borrowers, by Berlin and Mester (1999) that found a negative association between competition and the cost of finance, and by Beck et al (2004) for more concentration or market power in banking sectors that increases financial obstacles to smaller firms in accessing finance for their growth. Competition of the banking sector implies lower interest rates what goes to higher competition of real economy. According to that increase and decrease of interest rates is one of preconditions for financial stability.

Because of the shortcomings of profit as an indicator of competition the traditional industrial organization literature offers a broad array of indicators that measure concentration in way to explain competition. Nevertheless, the paradigm of perfect competition, with prices equalling marginal costs and zero economic profits in the long-run, is almost non-observable in reality. Instead, firms tend to have some degree of market power, i.e., they are able to set and sustain positive mark-ups. Therefore, competition measures are important policy indicators. The new competition measure suggested by Boone (2008) is particularly suited to assess competition in a context of reallocation of resources in the economy. Boone's model is based on the notion, first, that more efficient firms (that is, firms with lower marginal costs) gain higher market shares or profits and, second, that this effect is stronger the heavier the competition in that market is. Boone develops a broad set of theoretical models (see Boone, 2000, 2001, 2004 and 2008, Boone et al., 2004, and CPB, 2000). Following Boone et al. (2004), and replacing "firms" by "banks", they consider a banking industry where each bank i produces one product q_i (or portfolio of banking products). The bank faces a linear demand curve of the form:

$$p(q_i, q_{j\neq i}) = a - bq_i - d\textstyle\sum_{j\neq i} q_j \qquad (3.1.)$$

and has constant marginal costs mc_i. It maximizes profits $\pi_i = (p_i - mc_i)q_i$ by choosing the optimal output level q_i. Boone et al. assume that $a > mc_i$ and $0 < d \leq b$. The first-order condition for a Cournot-Nash equilibrium can then be written as:

$$a - 2bq_i - d\Sigma_{i\neq j} q_j - mc_i = 0 \qquad (3.2.)$$

When N banks produce positive output levels, Boone et al. solve the N first-order conditions (3.2.), yielding:

$$q_i(c_i) = \left[\left(2\frac{b}{d} - 1\right)a - \left(2\frac{b}{d} + N - 1\right)mc_i + \sum_j mc_j\right] / \left[\left(2b + d(N-1)\right)\left(2\frac{b}{d} - 1\right)\right] \text{(3.3.)}$$

Boone et al. define profits π_i as variable profits excluding entry costs ε. Hence, a bank enters the industry if, and only if, $\pi_i \geq$ ε in equilibrium. Note that Equation (3.3.) provides a relationship between output and marginal costs. It follows from $\pi_i = (p_i - mc_i)q_i$ that profits depend on marginal costs in a quadratic way.

In this market, competition can increase in two ways. First, competition increases when the produced (portfolios of) services of the various banks become closer substitutes, that is, d increases (keeping d below b). Second, competition increases when entry costs ε decline. Boone et al. (2004) prove that market shares of more efficient banks (that is, with lower marginal costs c) increase both under regimes of stronger substitution and amid lower entry costs. Equation (3.3.) supports the use of the following model for market share, defined as

$$s_i = q_i / \sum_j q_j : \ln s_i = \alpha + \beta ln\, mc_i \qquad \text{(3.4.)}$$

The market shares of banks with lower marginal costs are expected to increase, so that β is negative. The stronger competition is, the stronger this effect will be, and the larger, in absolute terms, this (negative) value of β. The β parameter is the Boone indicator. For empirical reasons, Equation (3.4.) has been specified in log-linear terms in order to deal with heteroskedasticty. Moreover, this specification implies that β is an elasticity, which facilitates easy interpretation, particularly across equations. The choice of functional form is not essential, as the log-linear form is just an approximation of the pure linear form.

The Lerner index of monopoly power is a nonstructural indicator of the degree of market competition developed in the context of industrial economics. The computation of the index, which provides measures of competition at the firm level, allows the investigation of the causality between efficiency and competition at the firm level to be carried out. The Lerner index has been computed in several empirical studies on banking competition (e.g., Angelini and Cetorelli 2003; Maudos and Fernández de Guevara 2007; Fernández de Guevara et al. 2005.). It is defined as the difference between price (calculated as the ratio of total costs to total assets) and marginal cost (expressed as a percentage of prices) divided by price. The Lerner index measures the degree to which firms can mark up output prices over the marginal cost of production. It can be approximated empirically using the translog functional form with three inputs and a single bank output (Shaffer 1993; and Berg and Kim 1994). It is assumed that the flow of goods and services by banks is proportional to its assets; the price of assets is computed as total interest income divided by total assets. To derive the marginal cost, a translog cost function with one output and three input prices was estimated. Cost functions were derived based on three subperiods to allow coefficients of the cost function to evolve over these periods.

One of the most widely used techniques to study competitive conditions in the banking system is the Panzar and Rosse (1987) framework, commonly known as the PR-H statistic. The framework primarily studies the impact of changes in factor input prices (cost) on the (equilibrium) revenue of the banking system. Specifically, the PR-H statistic is the sum of factor input price elasticities of the reduced form revenue equation of a bank or the banking system. Under perfect competition, the PR-H statistic assumes the value of 1.0, as a change of 1.0 percent in cost will lead to a 1.0 percent change in revenues. On the other hand, the PR-H statistic is zero (or less than zero) under a monopoly. In this case, an increase in input prices will increase marginal cost, reduce output and ultimately decrease revenue. The model also suggests that the value of the PR-H statistic will fall between 0 and 1 in case of monopolistic competition.

Other studies specified different models of competition, including conjectural-variations Cournot models to test for price-taking versus price-setting behavior (e.g., Berg and Kim 1998), models that test the role of sunk costs in determining concentration (e.g., Dick 2003), a model of simultaneous competitive imperfections in both output markets (loans) and input markets (deposits) (Adams, Roller, and Sickles 2002), non-structural models of competition, such as the Panzar-Rosse model (e.g., Bikker and Haaf 2002), and structural demand models based on consumer choice under product differentiation (e.g. Dick 2002).

Some of the recent research on the effects of bank competition allows for the possibility that different sizes of banks may affect competitive conditions differently. Small banks are often considered to be “community banks” with different competitive advantages than large banks. Relative to large banks, small banks in developed nations tend to serve smaller, more local customers, and to provide more retail-oriented rather than wholesale-oriented financial services (e.g., DeYoung, Hunter, and Udell 2004).

The main finding is that the degree of concentration of a banking sector is a relevant input that impacts on the level of competition of the financial system, but at the same time there are other variables that affect the way banks interact with each other and the overall competition environment in the system. Variables such as the political and cultural heritage, the contestability of the markets, the institutional and regulatory framework and the economic and business cycle, among others, may have a significant impact on the level of competition in the banking system (Zurita, 2014).

4. Interconnection among bank concentration, bank competition and financial stability

While the banking sectors in European Union is widely acknowledged for its rapid progress in last decades, debates still abound about the concentration of business and the associated impact on efficiency and the evolving market structure of the industry, especially since competition is an important dimension of efficiency. There is no banking system in the EU which did not pass through various changes. Croatian financial system, as well as financial systems in other transition economies in Europe, has in last decades been strongly influenced by the globalization process taking place under the auspices of the World Trade Organization. The basis of those changes is in the Washington Consensus from 1989. The Washington Consensus adopted for the economies in transition represents the agreement between the Governments of the debtor countries and international institutions. Core of agreement is on the implementation of neoliberal approach to administering the country, which means greater emphasis on the free functioning of markets, institutions and price without government impact, liberalization of foreign trade sector and overall reduction of government importance on the national economy. The neoliberal approach meant liberalization and deregulation of all segments of the economy. At the outset of WTO over 70 members took on some obligations, out of which about 60 members for the liberalization of the banking sector and 10 for the insurance industry. Liberalisation of the financial sector is achieved through external and internal liberalization of capital account over time i.e. through several stages with the possibility of retaining a certain degree of restriction. For each country this process had its individual path, but the goals were, with no doubt, to reduce the restrictions in this sector, to abolish monopolies, to increase competition which consequently contributes to faster economic growth in the national economy and to ensure an efficient allocation of resources.

At the beginning of transformations of economy, financial systems in countries with similar characteristics of economy like Croatian were highly bank based financial systems with mostly state owned banks and undeveloped non-banking sector. With all general efforts what include the Washington Consensus and world globalization process there is also trends which causes changes in financial/banking sectors: the deregulation of financial services at the national level and country opening to international competition, expansion of informatization, growing disintermediation and increased emphasis on shareholder value. The banking systems in CEE countries have been transformed as a result of privatization of state-owned banks that had dominated their banking systems in the early 1990´s. The period was marked by crucial structural changes which can be described by the entry of foreign capital, the growth in credit activities in particular to households, the improvement in profitability, high and satisfactory rate of capital adequacy despite credit expansion and the growth of risk assets and the improvement of supervisory framework. According to those facts, the new international banking architecture has been affected, in first way, by financial liberalization. Indeed, the various measures of the latter have increased interbank competition what strictly influence on main goal of bank business, profit. The market structure and profitability of banks constitutes a strong element in the analysis of banking industry, especially in the countries in which the level of the banking industry represents the main component of the financial system what is clearly obvious in Central Eastern Europe (CEE) countries. That structure of financial system is known as bank-based financial system. Further, that part of Europe is synonym for changes in their banking industries which are effect of mutation at the level of the structure of shareholding as a result of bank privatization, then of the entry of foreign banks and of the increase of competition determined by the liberalization of the market and changes in supervision and regulation. The early stages of banking transition in South-eastern European countries consisted in the restructuring of state banks and in abandoning direct financing. Reconstruction leads to bank privatization and growth of financial markets. The period of transition of the banking industry included significant structural changes which had some basic features: 1. Entry of foreign capital; 2. Growth in domestic lending in particular for consumption primarily for consumption of foreign goods; 3. Increase in the exposure to foreign currency risk; 4. Increase in profitability and a satisfying rate of capital adequacy; 5. Implementation of international accounting standards; 6. Changes in the regulation and supervision; 7. Credit expansion and growth of risk assets.

The analysis of banking competition and concentration has been of great concern in the literature, especially due to its effects on the financial stability (Beck et al., 2006; Schaeck et al., 2009; Wagner, 2010). A competitive banking market may result in more benefits to the society as a whole, such as lower prices and higher quality of financial products (Boyd and Nicol´o, 2005), but on the other hand its influence on financial stability is not conclusive according to the literature. Usually researches are based on relation between bank profitability and concentration what is one of condition for adequate investigation relation among concentration, competition and financial stability. According to that point of view here is literature review on selected topic and comparable variables and methodology.

Within the existing literature on the profit-structure relationship, most studies find empirical support for the assumed positive relationship between bank profitability and a measure of market structure, such as market share or some other measure of concentration (e.g. concentration ratios or a Herfindahl index), although this evidence is weak at times (Punt and van Rooij, 2001). There is some other benefits of high concentration and they are: 1. Banks of large size are easily diversified. This allows them to adjust in other sectors of the market when one sector takes a turn for the worse: a smaller bank that focuses on one or two sectors of the industry is highly vulnerable to fluctuations within those sectors. 2. High concentration levels will increase profits for the dominant banks within the industry: while this may lead to higher interest rates and fees it will also insulate banks from economic shocks. Also, with higher franchise values banks will have less incentive to take financial risks in pursuit of profits (Helen, Murdoch, and Stiglitz). 3. Larger banks are more easily monitored than many small banks. It is easier for a regulatory commission to look after a few large banks then many small ones. Systems within each of the large banks will be similar rather than having to learn the systems of many small banks.

On the basis of the obtained results, Erins and Erina (2013) conclude that internal and external bank performance indicators may not affect the profitability of CEE countries banks directly, except such indicators as credit risk and bank size, which influence one of the bank profitability indexes – return on average equity. Boyd, De Nicolo and Al Jalal (2006) explored relationship between concentration and banks risk of failure, using z-score as an empirical risk measure. Their results revealed a positive association between market concentration and risk of failure, driven primarily by a positive association between concentration and volatility of the rate of return on assets. Andries and Asandului (2010) analyse the impact of financial liberalization on banking performances, highlighting the determination of the impact of the presence of foreign banks on the performance of the Romanian banking system. The analysis reveals the fact that the liberalization and internationalization of the banking system had as effect the increase of competition which determined domestic banks: to reduce their operational costs concomitantly with investing some important amounts into new technologies; to increase their credit portfolio in relative terms by reducing other assets and increasing the client base, which led to the increase of the credit risk and to the increase of the bank provisions; to diminish their net interest margin by decreasing the interest rate for loans, concomitantly with increasing the interest rate for deposits.

Ramlall (2009) has discovered a positive correlation between bank size and profitability: the bigger is the bank, the more profitable it is in comparison with a smaller bank due to economies of scale. On the other hand, Hannan and Prager (2009) note that small banks can earn higher profit because they have lower expenses and better performance efficiency. Bailey (2007) examined the nature of the relationship between concentration (measured by HHI) and profitability (presented with ROA and NIM) by utilizing a dynamic VAR framework.

The results of the conducted analysis did not support the SCP hypothesis. Moreover, results showed that improvements in efficiency contributed to increased profitability for the dominant bank. Brissimis et al. (2008) examine the relationship between banking sector reform and bank performance – measured in terms of efficiency, total factor productivity growth and net interest margin – accounting for the effects through competition and bank risk-taking. The model is applied to bank panel data from ten newly acceded EU countries. The results indicate that both banking sector reform and competition exert a positive impact on the bank efficiency, while the effect of reform on total factor productivity growth is significant only by the end of the reform process. It is unavoidable to study some researches with impact of financial crisis. According to that, Andries et al. (2012) show large differences between pre-crisis period and crisis period and among the banking systems in terms of performance indicators. In average, banks from countries that are not members of European Union recorded an ample decrease of profitability and stability during current financial crisis. They observe that the best-performing banks during current financial crisis had significantly more core equity capital and are more focus on traditional banking activities.

Being exposed to advantage of the requirements of various changes on financial markets, the bank was marked by extensive restructuring, including the strategy of concentration seems the best solution for better banking performance. In this context, increasing the concentration of banking in theory allows to create value, gain market power and generate economies of scale and scope in order to seek greater efficiency. Two distinct views in the literature reflect contrast on the relationship between concentration and stability. In theoretical models, Allen and Gale (2000, 2004) exemplify that financial crises are more likely to occur in less concentrated banking systems. This is due to the absence of powerful providers of financial products that can reap benefits from high profits that serve as a cushion against asset deterioration. A similar view is taken by Boot and Greenbaum (1993) who highlight that increasing bank charter values arising from increased market power create incentives for bank management to act prudently thereby contributing to higher bank asset quality. These institutions are also considered to be easier to monitor from a regulatory perspective.

Relation between bank competition and growth cannot impact without banking stability. The financial stability of a bank constrains the capability of lending to industries, which affects growth. For instance, the higher the amount of non-performing loans in assets, the more the provision of funds is needed to put aside from the banking business in order to prevent a risk of potential defaults. The required provision restricts the lending ability of the bank, which in turn affects growth. This argument is evident by study that the effect of the financial stability constraint on growth is robust in estimation. The improvement of financial stability reduces the constraint on lending and so promotes growth. The empirical support to this expectation varies with regions. In developed economies, the constraint is significantly harder on growth; and in the emerging economies, it is soft or decoupled from the growth (Liu and Mirzaei, 2013). While some theoretical studies argue that competition erodes profits and tends to motivate banks to embark upon risky investments (Smith, 1984), others take a diametrically opposite view and argue that banks in uncompetitive, monopolistic markets with intermediate monitoring costs are prone to originate risky loans that set the stage for subsequent problems in the system (Caminal and Matures, 2002).

5. Banking industry throught concentration and competition in european union countries

Many of these changes have vast implications for competition and concentration in the banking and financial sectors. In 2013 the euro area banking sector continued its consolidation process, driven by continued pressure to achieve cost containment, deleveraging and restructuring. This process resulted in a further reduction of the total number of credit institutions in the euro area to 5,948 (down from 6,100 in 2012 and from 6,690 in 2008). Market concentration increased at the euro area level in comparison with the pre-crisis period; however, developments were quite heterogeneous across individual countries. The rationalisation and resizing process in the euro area banking system suggests that the overall efficiency of the system continues to be enhanced. Merger and acquisition activity, especially cross-border (intra-euro area) and outward transactions (with euro area banks as acquirers) were following a declining trend, both in terms of number of transactions and total value.

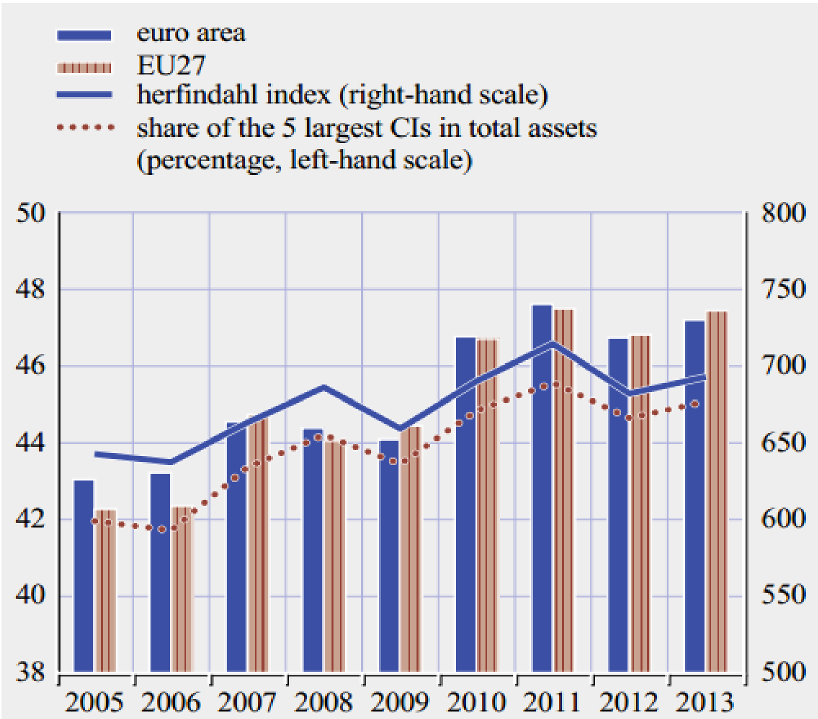

Chart 1: Market structure in EU (European Central Bank, 2014)

Since the inception of the financial crisis in 2008, the euro area banking sector has been going through a rationalisation process which has resulted in a reduction in the overall number of credit institutions. This banking sector consolidation process relates to pressures to achieve cost containment, deleveraging and restructuring, in particular in the banking sector of those euro area countries that were more severely affected by the financial crisis (ECB, 2014). At the end of 2013, the total number of credit institutions, including foreign branches, in the euro area was 5,948, down from 6,100 in 2013, if calculated on a non-consolidated basis. By comparison, at the end of 2008 there were 6,690 credit institutions, including foreign branches. Mentioned changes have significant impact on market concentration. Market concentration, as measured by the share of total assets held by the five largest credit institutions or by the Herfindahl index is shown on Chart 1. HH index has increased both at euro area and EU level since 2010 and in comparison with the pre-crisis period. This primarily reflects the decline in the number of credit institutions as M&A activity remained rather subdued. For both the euro area and the EU as a whole, the indicators peaked in 2011, fell slightly in 2012 and increased again in 2013, remaining well above the pre-crisis levels (ECB, 2014). The modest increase in 2013 was mostly driven by moves in the crisis countries where larger banks acted as consolidators in resolutions of non-viable entities – especially in Cyprus, Greece and Spain, what is visible in Chart 2.

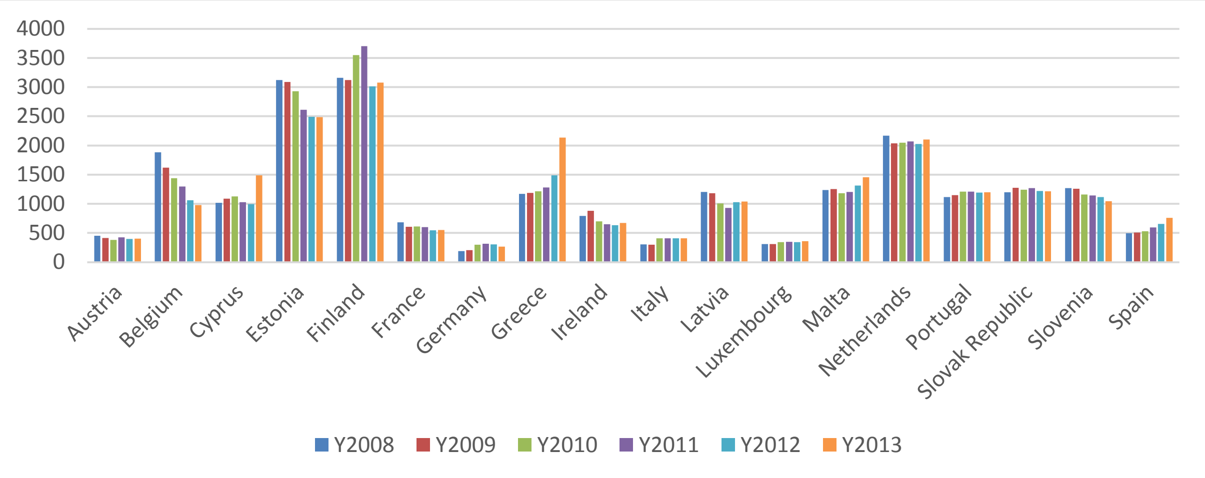

Chart 2: Herfindahl index for banking sector in EU countries (based on ECB, 2015)

With regard to cross-country comparison, concentration indices reflect a number of structural factors. Banking systems in larger countries, such as Germany and Italy, are more fragmented and include strong savings and cooperative banking sectors. Banking systems in smaller countries tend to be more concentrated, with the notable exception of Austria and Luxembourg. In the case of Austria, this is on account of a banking sector structure similar to that which characterises larger countries, and in the case of Luxembourg it is due to the presence of a large number of foreign credit institutions. At the end of 2013, market concentration (measured by the share of assets held by the five largest banks) ranged from close to 95% in Greece to just over 30% in Germany and Luxembourg (see Chart 3). Regarding developments in the period from 2008 to 2013, the banking sector structure tended to become more concentrated in a number of countries, in particular those undergoing deep banking sector restructuring processes such as Cyprus, Greece, Ireland or Spain (ECB, 2014).

In Croatia the share of total assets held by the two largest banks have cyclical trend what is obvious in data for 1996 when it was 46,3 then in 1998 40,5, in 2000 47,5 and in 2007 40,9 and in 3Q/2014 43,5. Situation with CR4 in Croatia is more stable and it is in last decade between 64,9 and 66,8 what is significantly higher than EU average. Further, although the number of small banks in Croatia has been on a continuous decline, their still relatively large number maintained moderate values of the Herfindahl-Hirschman index (HHI). HHI for assets stood at 1440 at the end of 2013, which was only 0.9% higher than at the end of 2012 but it counts positive trend from 2010 when it was 1361 but still much higher than EU average.

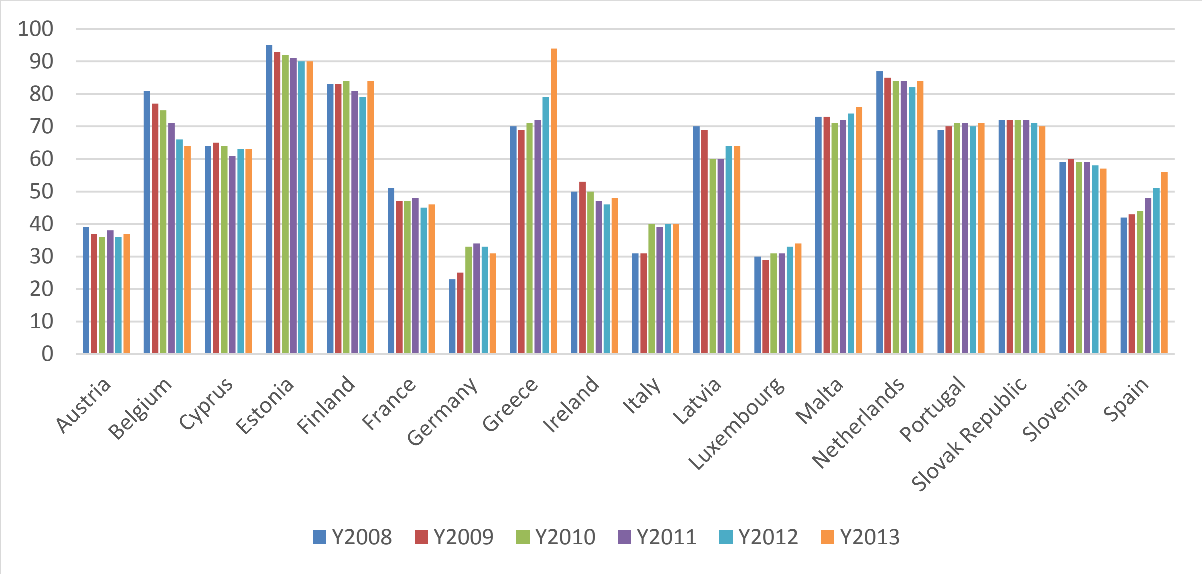

Chart 3: Share of the five largest credit institutions in total assets in EU countries (based on ECB, 2015)

In Chart 4 profitability measured with ROA, showed various trend between EU countries in period 2008 – June 2014 on a year over year comparison. There is worst result in small countries like Cyprus, Ireland, Latvia and Slovenia with worst decline in ROA in 2013 of 7,99%. Altought most countries have positive result throught all analysed years. In relation with concentration and return on assets it is seen that countries with worst financial results (average measure) have HHI approximately around 1000 points. All other results among countries goes to view that there is no significant evidence about correlation between concentration and financial results of banks.

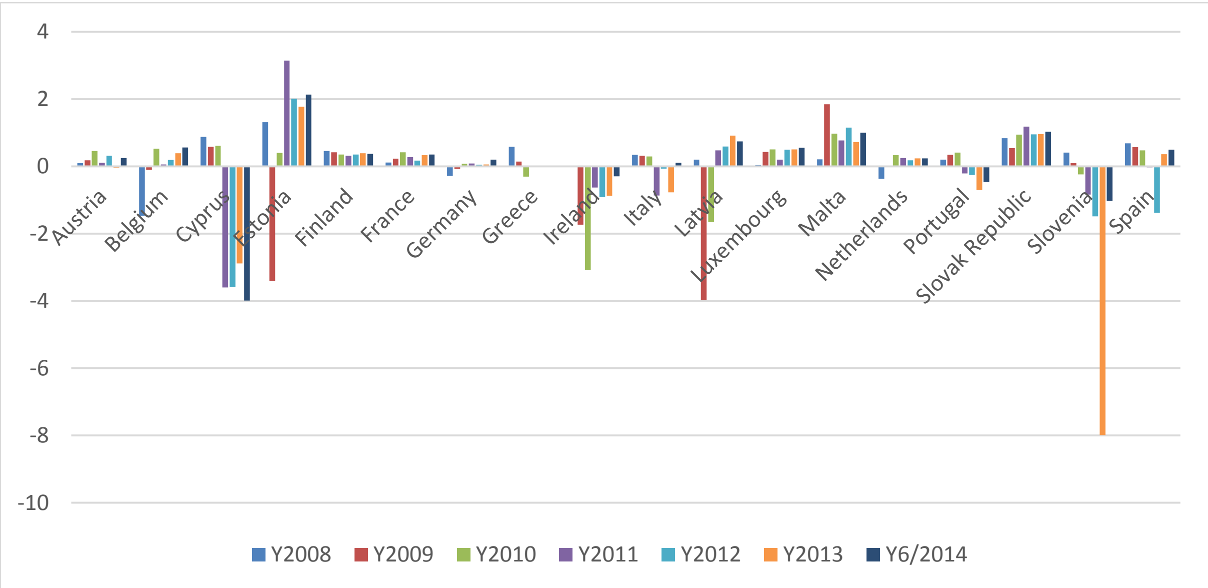

Chart 4: Return on assets (ROA) for selected EU countries (based on ECB, 2015)

6. Concluding remarks

In accordance with economic theory higher level of concentration leads to higher level of profits, when on the other side, competiton leads to lower profits. Banking sectors last decades, especially in emerging countries, were exposed on liberalization which outcome is lower levels of Herfindahl-Hirschman index. In that countries, banking sectors are dominantly in foreign ownership with high levels of concentration what was one of reason for increase in HHI for EU-27 countries. Also, financial crises and their effects on M&A in banking sector with bank failures across EU leads increase in HHI on EU level. This research has shown that HHI has positive correlation with level of economic development of country, it is lower in developed and higher in less developed countries. Also, there is correlation with country size where smaller countries have more concentrated banking sector. Croatia, as small transition economy, has not implemented all liberalization proceses yet although Washington Consensus was fully implemented. That proceses have outcome on financial stability today, but on the other side it decreases potencial of development of Croatian real economy.

In this paper we discuss the existence of a relationship between market concentration and the degree of competition in the banking systems with financial stability. The main finding is that no such link can be found as a general rule, further there is presented all significant measures of concentration and competition. It is not clear whether excessive competition and concentration contributed to the recent financial crisis and financial stability. This paper after research does not support the existence of a direct relationship between concentration and market power in the banking sector.

It is necessary to sustain high stability of banking industry what implies strog supervision and regulation with all of their impacts. According to that, it is important to implement all regulatory measures relating to concentration and competition guided from central banks and official authorities. Further researchs are needed to investigate the nature essence of the dynamic relationship between concentration and competition on financial stability and stability of real economy as well as impact of financial crises on concentration. For example, an analysis of the effects of competition in the short and in the long run may cause different outcomes for financial stability. Finally, on the basis of research, future papers need to use nonstructural measures of competition for measuring the level of competition.

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THE INTERDEPENDENCE OF GDP PER CAPITA AND FOREIGN DIRECT INVESTMENT IN THE TRANSITIONAL ECONOMIES OF CENTRAL AND EASTERN EUROPE

Abstract

The paper studies the influence of the GDP per capita on foreign direct investments (FDI) in transitional economies of Central and Eastern European states. In the literature devoted to the influence of FDI on economies, the research about the determinants of the geographical pattern of FDI distribution usually focuses on the factors that determine why some states manage to draw FDI in higher levels than some other states. However, not many studies deal with the GDP per capita as a determinant why some states (i.e. their economies) are more attractive to the FDI than others. Our research focused on the transitional economies of Central and Eastern Europe. Among the states studied, we have equally studied the EU members from Central and Eastern Europe, as well as the non-EU members. By using two variables, FDI and GDP per capita, this research will determine how much FDI correlate to the standard of living represented through GDP per capita for each state surveyed. Research results will show if FDI and GDP per capita are positively correlated, which represents our research hypothesis no.1 and if that correlation is more significant in non-EU states, which represents our hypothesis no. 2. States surveyed in this research were put into three geopolitical groups: two groups of non-EU states compared to a group of more recent EU states. The methodology is based on the calculation of Pearson's correlation matrix of GDP per capita and FDI for each state and the comparison of median correlation results between the mentioned groups of states. The period surveyed was between 1994 and 2013. We have tried to find similarities and differences between these two groups of states in order to determine the influence of EU membership on the correlation between FDI and GDP per capita.

Keywords

foreign direct investment (FDI), GDP per capita, transitional economies, Central and Eastern Europe, correlation

1. Introduction

An important aspect of the former is the possibility of reintegration into Europe symbolised for many countries by prospective membership of the European Union (Grabbe, Hughes, 1998; Mayhew, 1998). Integration into the world economy, notably through trade and capital flows, is a crucial and related element of the latter. Foreign direct investment (FDI) is a particularly important element of economic integration, because it opens possibilities for accelerated growth, technical innovation and enterprise restructuring, as well as capital account relief (Garibaldi et al, 1999; Holland, Pain, 1998). EU membership can be viewed as a

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determining element of the operating business environment, and this may directly influence the rate of FDI flows.

Most studies generally indicate that the effect of FDI on growth depends on other factors such as the degree of complementarity and substitution between domestic investment and FDI, and other state-specific characteristics. Buckley, Clegg, and Wang (2002) argue that the extent to which FDI contributes to growth depends on the economic and social conditions in the recipient state. States with a high rate of savings, an open trade regime and high technological levels would benefit from increased FDI to their economies. However, FDI may have a negative effect on the growth prospects of the recipient economy if they result in substantial reverse flows in the form of remittances of profits, and dividends and/or if the multinational corporations (MNCs) obtain substantial or other concessions from the host state. Bengoa and Sanchez-Robles (2003) argue that in order to benefit from long-term capital flows, the host state requires adequate human capital, sufficient infrastructure, and economic stability and liberalized markets.

In the literature devoted to the influence of FDI on economies, the research on the determinants of the geographical pattern of FDI distribution usually focuses on the factors that determine why some states manage to draw FDI in higher levels than some other states. However, not many studies deal with the GDP per capita as a determinant why some states (i.e. their economies) are more attractive to the FDI than others when it comes to the size of the economy itself. This paper studies the interdependence of the gross-domestic product (GDP) per capita and foreign direct investments (FDI) in transitional (i. e. post-communist) economies of Central and Eastern Europe. The economies of Central and Eastern Europe were picked and grouped as follows: 11 current post-communist EU member states (Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia), six states of the current Western Balkans (Albania, Bosnia-Herzegovina, Kosovo, Macedonia, Montenegro, Serbia), and three Eastern European states, members of the Commonwealth of the Independent States (Belarus, Moldova, Ukraine) . Among the states studied, we have equally studied the EU members from Central and Eastern Europe, as well as the non-EU members. By using two variables, FDI and GDP per capita, this research will determine how much FDI correlate to the standard of living represented through GDP per capita for each state surveyed. Research results will show if FDI and GDP per capita are positively correlated, which represents our research hypothesis no.1 and if that correlation is more significant in non-EU states, which represents our hypothesis no. 2. In order to see the correlation between the growth of the GDP per capita (taken from the web pages of the World Bank) and the FDI for each year surveyed, Pearson’s correlation matrix of GDP per capita and FDI for each state was used and a comparison of median correlation results between the mentioned groups of states was done. The period surveyed was between 1994 and 2013. The data used were collected from webpages of the World Bank. We have tried to find similarities and differences between these two groups of states in order to determine the influence of EU membership on FDI and how it correlates with the size of the state’s economy. Tables below show yearly GDP per capita and FDI values for each surveyed state, from 1994 until 2013.

Year	Bulgaria	Croatia	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Slovakia	Slovenia
1994	1.149	3.135	4.449	2.725	4.049	2.008	1.903	2.813	1.323	3.686	7.231
1995	1.555	4.722	5.596	3.031	4.411	2.107	2.178	3.603	1.564	4.710	10.524
1996	1.063	5.194	6.291	3.342	4.454	2.273	2.340	4.057	1.562	5.078	10.635
1997	1.210	5.140	5.771	3.609	4.522	2.521	2.833	4.066	1.565	5.023	10.282
1998	1.582	5.578	6.204	4.039	4.671	2.746	3.171	4.472	1.871	5.431	10.974
1999	1.611	5.068	6.045	4.132	4.714	3.049	3.113	4.340	1.584	5.550	11.250
2000	1.579	4.862	5.734	4.063	4.543	3.309	3.267	4.477	1.662	5.330	10.045
2001	1.729	5.192	6.301	4.495	5.175	3.557	3.503	4.979	1.834	5.637	10.290
2002	2.031	5.974	7.691	5.310	6.535	4.032	4.114	5.184	2.116	6.442	11.600
2003	2.642	7.690	9.348	7.182	8.247	4.889	5.449	5.675	2.756	8.530	14.607
2004	3.249	9.237	11.177	8.830	10.085	6.081	6.710	6.620	3.533	10.438	16.944
2005	3.733	10.090	12.738	10.264	10.937	7.165	7.851	7.963	4.652	11.415	17.855
2006	4.313	11.229	14.491	12.473	11.174	8.986	9.250	8.958	5.789	12.842	19.406
2007	5.581	13.372	17.524	16.405	13.535	13.073	12.170	11.157	8.170	15.649	23.462
2008	6.917	15.694	21.708	17.786	15.365	15.464	14.833	13.886	9.949	18.201	26.990
2009	6.524	14.044	18.881	14.542	12.635	12.082	11.714	11.295	8.069	16.196	24.126
2010	6.453	13.327	18.950	14.295	12.750	11.447	11.852	12.304	8.139	16.151	22.942
2011	7.286	14.372	20.585	16.982	13.784	13.827	14.228	13.385	9.064	17.760	24.478
2012	7.022	13.159	18.690	16.887	12.560	13.947	14.172	12.721	8.437	16.893	22.059
2013	7.296	13.530	18.861	18.478	13.134	15.375	15.538	13.432	9.499	17.689	22.729

Table 1: GDP per capita, CEE EU states, in current US dollars

Year	Albania	Bosnia-Herzegovina	Kosovo	Macedonia	Montenegro	Serbia	Belarus	Moldova	Ukraine
1994	619	343	n/a	1.717	n/a	n/a	1.460	461	1.012
1995	761	530	n/a	2.262	n/a	n/a	1.371	477	936
1996	951	799	n/a	2.239	n/a	n/a	1.452	462	873
1997	698	1.038	n/a	1.875	n/a	2.795	1.397	528	991
1998	872	1.131	n/a	1.774	n/a	2.141	1.512	449	835
1999	1.105	1.249	n/a	1.806	n/a	2.338	1.210	321	636
2000	1.193	1.436	1.088	1.748	1.610	809	1.273	354	636
2001	1.335	1.482	1.490	1.664	1.897	1.518	1.244	408	781
2002	1.458	1.707	1.588	1.828	2.098	2.014	1.479	459	879
2003	1.863	2.148	1.970	2.286	2.784	2.614	1.819	548	1.049
2004	2.476	2.579	2.135	2.644	3.373	3.169	2.378	721	1.367
2005	2.799	2.822	2.194	2.864	3.665	3.391	3.126	831	1.829
2006	3.077	3.200	2.279	3.133	4.371	3.943	3.849	951	2.303
2007	3.639	3.950	2.736	3.892	5.946	5.277	4.736	1.231	3.069
2008	4.423	4.802	3.303	4.686	7.336	6.498	6.377	1.696	3.891
2009	4.176	4.433	3.191	4.434	6.713	5.498	5.176	1.526	2.545

2010	4.175	4.362	3.233	4.442	6.636	5.073	5.819	1.632	2.974
2011	4.556	4.754	3.702	4.941	7.253	6.048	6.306	1.971	3.575
2012	4.406	4.396	3.567	4.548	6.514	5.294	6.722	2.047	3.873
2013	4.652	4.656	3.816	4.851	7.126	5.935	7.575	2.230	3.900

Table 2: GDP per capita, CEE and SEE non-EU states, in current US $

State	Bulgaria	Croatia	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Slovakia	Slovenia
1994	105	114	878	214	1.144	214	31	1.875	341	270	117
1995	90	108	2.568	201	4.804	180	73	4	419	236	150
1996	109	493	1.435	150	3.289	382	152	4	263	351	173
1997	505	541	1.286	266	4.155	521	355	5	1.215	174	335
1998	537	941	3.700	581	3.343	357	926	6	2.031	562	216
1999	819	1.452	6.313	305	3.308	348	486	7	1.041	354	107
2000	1.002	1.110	4.987	387	2.770	413	379	9.343	1.037	2.052	136
2001	813	1.582	5.641	542	3.944	132	446	5.714	1.157	n/a	503
2002	905	1.100	8.497	285	3.013	254	712	4.131	1.144	4.104	1.660
2003	2.097	2.049	2.021	919	2.177	304	179	4.589	1.844	559	302
2004	2.662	1.079	4.978	966	4.282	637	773	12.716	6.443	3.037	831
2005	4.098	1.777	11.602	3.127	8.505	812	1.189	11.051	6.866	2.998	971
2006	7.874	3.220	5.522	2.212	18.679	1.702	2.052	21.518	11.451	4.072	692
2007	13.875	4.947	10.606	3.429	70.631	2.714	2.325	25.573	10.290	3.890	1.885
2008	10.297	5.813	6.573	1.873	74.992	1.435	1.908	15.031	13.849	4.076	1.823
2009	3.897	3.401	2.869	1.867	-2.966	-44	19	14.388	4.926	1.605	-354
2010	1.867	845	6.119	2.052	-20.934	433	863	17.074	3.204	2.118	634
2011	2.124	1.243	2.249	521	10.500	1.502	1.443	17.357	2.557	3.658	817
2012	1.578	1.336	7.976	1.648	9.779	1.076	574	6.701	2.629	1.527	-227
2013	1.888	588	5.007	910	-732	881	712	-4.586	3.729	2.148	-419

Table 3: Foreign Direct Investment, CEE EU states, in current US million $

	Albania	Bosnia-Herzegovina	Kosovo	Macedonia	Montenegro	Serbia	Belarus	Moldova	Ukraine
1994	53	n/a	n/a	24	n/a	63	11	12	159
1995	70	n/a	n/a	9	n/a	45	15	26	267
1996	90	n/a	n/a	11	n/a	0	105	24	521
1997	48	n/a	n/a	16	n/a	740	352	79	623
1998	45	n/a	n/a	150	n/a	113	203	76	743
1999	41	n/a	n/a	88	n/a	112	444	38	496
2000	143	146	n/a	215	n/a	52	119	128	595
2001	207	118	n/a	447	n/a	177	96	55	792
2002	135	268	n/a	106	n/a	567	247	84	693
2003	178	382	n/a	118	n/a	1.406	172	74	1.424
2004	341	710	n/a	323	n/a	1.028	164	88	1.715
2005	262	624	134	145	n/a	2.051	307	191	7.808

2006	325	846	370	427	n/a	4.968	357	259	5.604
2007	652	1.804	603	733	938	3.432	1.807	536	10.193
2008	1.241	1.005	537	612	975	2.996	2.188	727	10.700
2009	1.343	139	408	260	1.549	1.936	1.877	135	4.769
2010	1.089	444	487	301	758	1.340	1.393	202	6.451
2011	1.049	469	546	495	556	2.700	4.002	276	7.207
2012	920	350	293	283	618	355	1.464	185	7.833
2013	1.478	322	343	376	446	1.377	2.233	251	3.771

Table 4: Foreign Direct Investment, CEE and SEE non-EU states, in current US million $

2. Results and discussion

2.1. Methodology

The methodology is based on the statistical correlation between FDI in current US dollars and GDP per capita in current US dollars (World Bank data) for each represented state (as seen in Table 2.), through the surveyed period from 1994 until 2013. The statistical correlation matrix (Pearson method) determined whether any correlation between FDI and GDP p/c exists for each state surveyed, and also if the median value of the individual correlation is higher or lower in non-EU states in comparison to EU states. All surveyed states are put into 3 groups (CEE EU states, CEE non-EU states and SEE non-EU states). It must be mentioned that this research has unavoidable limitations in the surveyed period of years. Less than 35 years were surveyed because there is not enough historical data. Along with that, Bosnia-Herzegovina, Kosovo and Montenegro have insufficient data, because of which their P-value was not significant and the NULL hypothesis was accepted. Finally, research results provided in this paper do not show any cause-consequence relation between FDI and GDP p/c. Any conclusion like that would be false, for example if one wants to conclude that FDI affects the standard of living represented through GDP p/c. A statement like that cannot be concluded because far more variables would have to be considered first.

Research base-points:

Research Hypothesis No.1: In average, a positive correlation between FDI and GDP p/c exists among surveyed states.

Research Hypothesis No. 2: Non-EU states have, in average, a stronger correlation between FDI and GDP p/c than EU states.

The NULL Hypothesis: FDI and GDP p/c are unrelated among surveyed states.

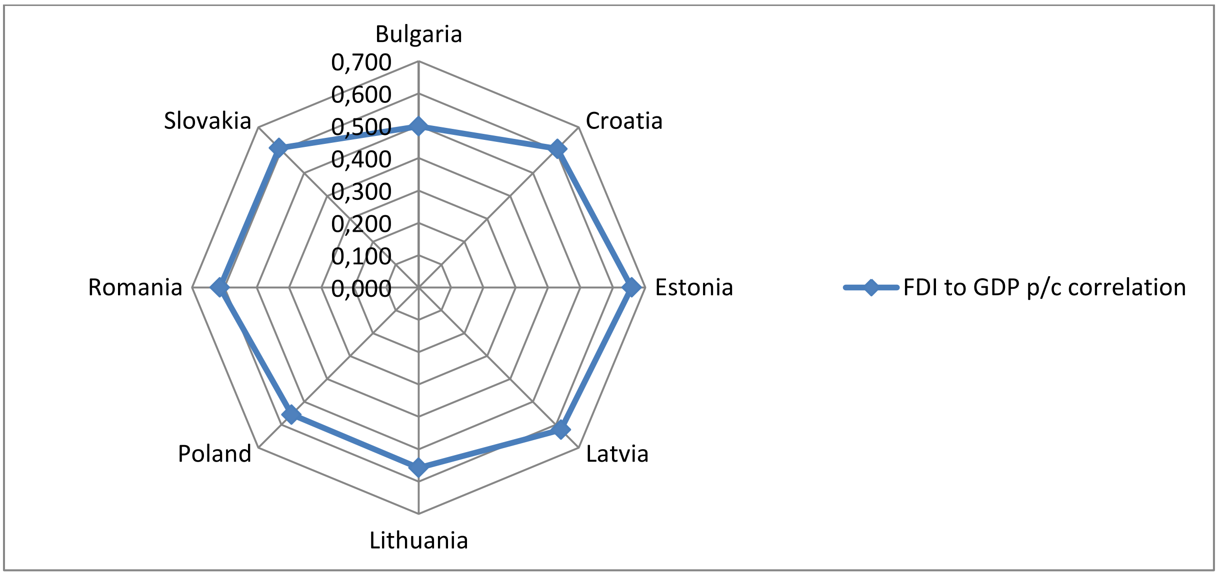
2.2. Research results

Research results show that, for most states (14 out of 20), the NULL Hypothesis can be rejected, which means that FDI and GDP p/c ARE RELATED among surveyed states. In addition, in average, we can accept research hypothesis no. 1 and conclude that there is a somewhat positive correlation between FDI and GDP p/c (standard of living) among the surveyed states, which is shown in Table 5.

	COUNTRIES	Pearson Correlation value (r) between FDI and GDP p/c	P-value	NULL Hypothesis at P=0,05:
CEE EU states	Bulgaria	0,498	0,025	rejected
	Croatia	0,606	0,005	rejected
	Czech Republic	0,340	0,142	confirmed
	Estonia	0,658	0,002	rejected
	Hungary	0,431	0,058	confirmed
	Latvia	0,622	0,003	rejected
	Lithuania	0,557	0,011	rejected
	Poland	0,555	0,011	rejected
	Romania	0,614	0,004	rejected
	Slovakia	0,631	0,003	rejected
	Slovenia	0,265	0,258	confirmed
	MEDIAN	**0,608**		
CEE non-EU states	Albania	0,932	0,000	rejected
	Bosnia-Herzegovina	0,302	0,295	confirmed
	Kosovo	0,327	0,390	confirmed
	Macedonia	0,641	0,002	rejected
	Montenegro	-0,232	0,616	confirmed
	Serbia	0,582	0,015	rejected
	MEDIAN	**0,641**		
SEE non-EU states	Belarus	0,851	0,000	rejected
	Moldova	0,597	0,005	rejected
	Ukraine	0,857	0,000	rejected
	MEDIAN	**0,851**		
	MEDIAN Correlation: ALL non-EU	0,746		
	MEDIAN Correlation: ALL	0,612		

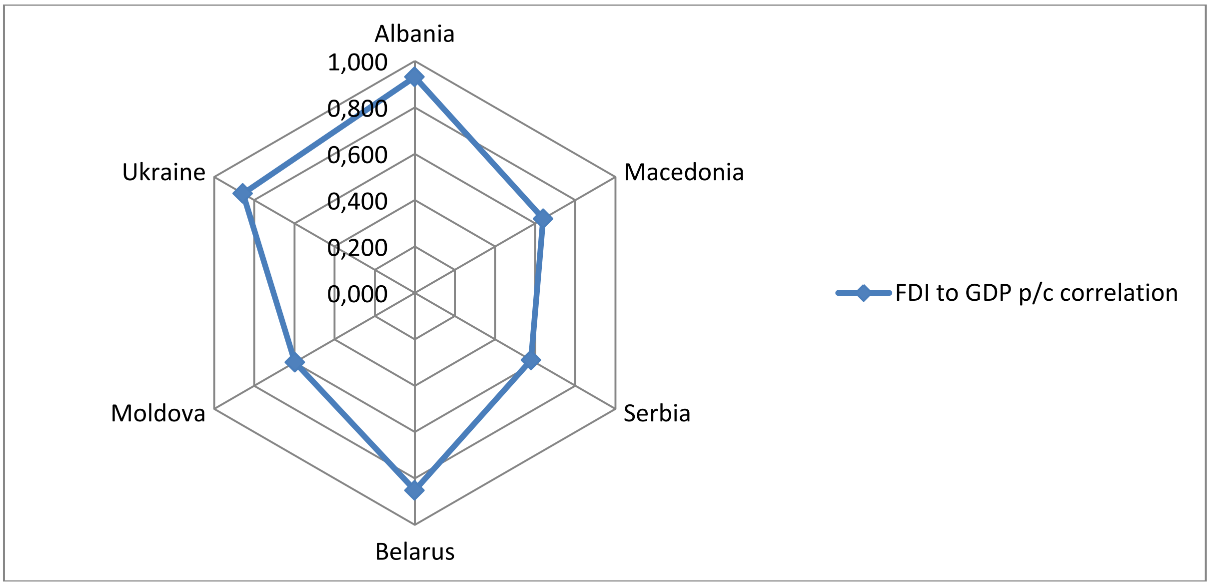
Source: Authors' research and calculation based on World Bank data, FDI and GDP p/c in current US$

Table 5: FDI to GDP p/c correlation between CEE EU member states, CEE non-EU member states and SEE non-EU member states (Belarus, Moldova, and Ukraine)



Source: Authors' research and calculation based on World Bank data, FDI and GDP p/c in current US$

Figure 1: FDI and GDP p/c correlation, CEE EU countries (the countries that have rejected the NULL Hypothesis)



Source: Authors' research and calculation based on World Bank data, FDI and GDP p/c in current US$

Figure 2: FDI and GDP p/c correlation, CEE and SEE non-EU countries (the countries that have rejected the NULL Hypothesis)

Among the surveyed states, the ones that statistically do not have a relation between FDI and GDP p/c (confirmed the NULL hypothesis) are the Czech Republic, Hungary and Slovenia. States that have insufficient data to determine a statistical correlation between FDI and GDP p/c are: Bosnia-Herzegovina, Kosovo and Montenegro.

All other surveyed states have rejected the NULL hypothesis. Out of the states that have rejected the NULL hypothesis, the authors can conclude that the median correlation values between FDI and GDP p/c among non-EU states are higher than among EU-states.

	Median value of Correlation between FDI and GDP p/c
CEE EU states	0,608
CEE non-EU states	0,641
SEE non-EU states	0,851

Source: Authors' research and calculation based on World Bank data, FDI and GDP p/c in current US$

Table 6: FDI/GDP p.c. correlation median between three groups of countries

Based on data from Table 6, the authors can conclude that, in average, Non-EU states have a stronger correlation between FDI and GDP p/c than EU states surveyed, which confirms Research Hypothesis no. 2.

3. Conclusion

Research results have obviously shown and proven that there is a relation between FDI and GDP per capita. Although it would be difficult to prove that it is a causal relation (it would not be statistically correct) one can notice that there is some influence between FDI and GDP per capita when the size of the economy (measured in GDP) is taken into consideration. If one lived, for example, in Belarus, his or her standard of living might be more related to FDI than, for example, if he or she lived in Poland. The main point of this argument can be seen above in Table 6, in which smaller, non-EU Central and Eastern European economies have a higher correlation, or simply stronger connection between FDI and GDP per capita (standard of living) than larger, mainly EU economies.

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SUSTAINABILITY REPORTING: POSSIBLE WAYS OF RETHNINKING HOSPITALITY ACCOUNTING

Abstract

The concept of sustainability reporting has emerged from developments in accounting, with roots over a period of the last forty years in a broader sense and in the narrow sense over the last ten years. While the term sustainability accounting is used to describe accounting methods that aim to create and provide high quality information to support a corporation in its movement towards sustainability, sustainability reporting, describes new formalized means of communication, which provides information about corporate sustainability. Sustainability accounting is a framework that can be used to reflect economic, social and environmental impacts and demonstrate their connection.

In order to get an idea of whether sustainability reporting has been implemented in Croatian companies, the purpose of the paper is to investigate the achieved level of sustainability reporting in Croatia. The paper will also critically review previous research results about sustainability reporting in the hospitality industry and develop a framework for hotel sustainability reporting, in accordance with the Uniform System of Accounts for the Lodging Industry – USALI (11th edition, 2014), Global Reporting Initiative (GRI) and the new EU Directive about disclosure of non-financial and diversity information

Keywords

sustainability reporting, hospitality accounting, sustainability accounting

1. Introduction

Accountability is the duty to provide information to stakeholders who have a right to it and an essential component of sustainability strategies. It is the information related to responsibility and is as much about what has not been done as it is about what has been done. The new challenge of hospitality business is how to be more accountable towards stakeholders.

The hospitality industry is a significant consumer of resources with a considerable impact on natural environments, economies, cultures and societies. Hotel companies are under the pressure from stakeholders and competitors to enhance their sustainability in "every day" business. Therefore, hotel companies that apply sustainable business must provide products and services that people want in order to generate profit, growth and new jobs, while taking

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into account their social and environmental impact, as a part of ensuring that they generate added value for an organization and its stakeholders (IFAC, 2011, p. 8).

In accordance with that, the triple bottom line (TBL) approach was developed to measure the financial performance, as well as the achieved level of social and environmental responsibility. Of particular interest is also the new EU Directive (No. 2014/95 & 2013/34) which requires obligatory disclosure of non-financial and diversity information by certain large companies.

In a business environment that expects social responsibility of companies and respect for the principles of sustainable development, hotel companies have to find a way to achieve balance between social, environmental and financial performance, and in that process sustainability reporting is of a great importance.

2. Framework for sustainability reporting

Sustainability reporting describes new formalized means of communication, which provides information about corporate sustainability (Schaltegger, Bennett & Burritt, 2006, p. 15). The goal of sustainability reporting is „to inform development of an integrated business strategy for corporate management and assess sustainability risks and opportunities inherent to investment decisions“ (SASB, 2013, p. 3). The demands from various stakeholders for increased levels of transparency and disclosure, and also the need for companies to appropriately respond to issues of sustainable development, are the main factors of development of sustainability reporting. Sustainability reporting is a vital step to achieving smart, sustainable and inclusive growth (EUROPE 2020, 2010) that combines long-term profitability with social justice and environmental care (GRI, 2013).

From its origins until today, there were considerable changes and advancements in sustainability reporting, going from standalone environmental and social reports, to triple bottom line (TBL) reports and at the end to sustainability reports. It is important to emphasize the distinction between TBL reports and sustainability reports. Since TBL reports in its essence display company's results in economic, environmental and social dimensions without showing any connections between the dimensions (Schaltegger, & Burritt, 2010), sustainability reporting presents also the correlations among the three dimensions and interpretation of how it affects their business.

In the interest of delivering sustainability reports that communicate improved performance in the process of defining report content some accounting principles should be followed. According to Lamberton (2005), main sustainability accounting principles are definition, accounting period, scope, materiality, capital maintenance, units of measurement and precautionary principle. In addition to this, content should be transparent, stakeholder inclusive, provide sustainability context and allow auditing (GRI, 2002).

During the last decade number of companies producing sustainability reports has largely increased. According to the 2013 KPMG survey corporate responsibility reporting (that is regarded as sustainability reporting) "is undeniably a mainstream business practice worldwide, undertaken by 71% of the 4.100 companies surveyed, and 93% among the world's largest 250 companies (G250)" (KPMG, 2013, p. 11), compared to "35% of G250 companies undertaking environmental reporting in 1999" (KPMG, 1999). The high rates of corporate responsibility reporting in all regions suggest that it is now standard business practice worldwide, so the KPMG view is that companies should no longer ask whether or not they should publish a corporate responsibility report but about the quality of the reporting and the best means to reach relevant audiences (KPMG, 2013). According to their research large companies in the electronics and computers, mining and pharmaceuticals sectors produce the highest quality sustainability reports. For large companies sustainability reporting should not represent an additional financial burden.

The incentive for sustainability reporting comes from different national initiatives, professional accountants associations, consultant organizations etc. Current international examples are Global Reporting Initiative (GRI), the principles of the United Nations Global Compact (UNGC), the Standard ISO 26000, OECD Guidelines and the new EU Accounting Directive of disclosure of non-financial and diversity information.

The most representative international initiative is the Global Reporting Initiative. GRI provides sustainability reporting framework to promote usage of environmental, social and economic performance indicators. By using environmental performance indicators organizations worldwide asses their environmental performance, comply with the principles of sustainable development and disclose achieved results. Some countries (e. g. Austria, Belgium, Denmark, Finland, Canada, Netherland, Germany, Norway, USA, Sweden) officially refer to GRI guidelines in their own guidelines and standards for corporate social responsibility accomplishment and environmental responsibility and/or in their environmental policies. GRI, affiliated with the United Nations Global Compact Initiative (the initiative which also supports business sustainability and sustainable reporting), constitutes the biggest international incentive for promoting corporate sustainability, and sustainable and environmental reporting.

One of the newly emerged tools is Sustainability Balanced Scorecard that is based on the Norton and Kaplan's concept of Balanced Scorecard but a fifth dimension – the sustainability perspective has been added. Poldrugovac and Tekavčić (2013) found nine different approaches on how to integrate sustainability into Balance Scorecard. So currently, there is no general agreement on what this sustainability perspective should consist of.

There are some other initiatives for sustainability reporting framework development. The International Federation of Accountants (IFAC) together with the GRI and The Prince's Accounting for Sustainability Project established The International Integrated Reporting Comitee (IIRC), a body to oversee the creation of a globally accepted Integrated Reporting Framework, which combines financial, environmental, social and economic information into a comprehensive format and shows mutual influences. The framework should elict material information from organizations about their strategy, governance, performance and prospects in a clear, concise and comparable format. The Framework is intended to underpin and accelerate the evolution of corporate reporting, reflecting developments in financial governance, management commentary and sustainability reporting (Integrated reporting, 2011).

Of particular interest today is the latest EU accounting Directive (No. 2014/95 & 2013/34) which includes obligatory disclosure of non-financial and diversity information by certain large undertakings and groups (Directive, 2014) and amends the existing EU accounting legislation to increase the relevance, consistency and comparability of disclosed information. The new legislation introduces additional non-financial disclosure requirements for large public interest entities to include a non-financial statement in their management report containing information on: environmental matters, social and employee-related aspects, respect for human rights, and anti-corruption and bribery issues (FEA, 2014).

According to the new accounting Directive, large public-interest companies with more than 500 employees are required to disclose relevant and material environmental and social information in their annual reports. Member States have to transpose the starting points of this Directive into national law by the end of 2016, and the new provisions have to be applied to all undertakings within the scope for the financial year, starting on 1 January 2017 or during the calendar year 2017. The accounting Directive requires that companies describe their business model, outcomes and risks of the policies on the mandatory topics, and encourages them to rely on recognized frameworks such as GRI Guidelines, UNGC, OECD Guidelines and ISO 26000. It promotes transparency and accountability of the companies and enables managers to use the potential of CSR in order to increase companies' competitiveness while contributing to sustainable growth in the EU.

3. Social and environmental reporting in Croatian companies: research results

The research of assessing the environmental and social responsibility of Croatian companies was conducted in spring 2013, and is based on exploring the site of HR BCSD (The Croatian Business Council for Sustainable Development) founded in 1997 as an independent non-profit association. It includes 39 members in total, of which 19 from the industrial sector, 9 representatives of big service industries as tourism, banking and utilities, and others in small businesses, consulting agencies, expert institutions, environmental NGO, media, private business school and one institution from Slovenia (http://www.hrpsor.hr). As not all member companies publish information on sustainability and environmental care, only 23 presented reports of Croatian companies were analyzed.

It is indicative that only 59% of HR BCSD members present their reports for the public use (AGROKOR; Highway Rijeka-Zagreb; Banco Popolare Croatia; Carlsberg Croatia; Coca-Cola Beverages Croatia; DUKAT; Ericsson Nikola Tesla; Farmal; Hartmann Croatia; Hauska & Partner; HEP - Croatian Electric Power Industry; Holcim; Croatian Telecom; INA; Adriatic Galenical Laboratory; Stone Sirač; KONČAR; Končar - Institute of Electrical Engineering; PLIVA; PODRAVKA; T-HT group; The Bank of Zagreb; Zagreb Airport). These reports were prepared in the period from 2003 till 2011 and present current state of corporate social responsibility, following experiences and global key trends in environment, supply chain, human rights, engagement in the community, sustainable products and services and others (http://www.hrpsor.hr). This indicates that only a small number of Croatian companies follow trends and experiences of environmental and sustainability reporting, according to accepted standards and principles (GRI, UN Global Compact's requirements, ISO 14001, EMAS ….).

There is no regulation regarding reporting on corporate social responsibility and sustainable development in Croatia (CSR, 2010: 14). The research results indicate that this type of reports is not present in continuous nor in standardized form and content. Some companies present reports mainly every year (Pliva; Highway Rijeka-Zagreb), some every two years (Holcim), some in reports present information for two or more years (Agrokor; Zagreb Airport) and some make combinations between more possibilities (Coca-Cola Beverages Croatia; T-HT group). Some of the companies, which present this type of reports on regular basis (since 2003), others have given up on reporting them (Ericsson Nikola Tesla; Hauska & Partner; INA; Stone Sirač; Podravka; The Bank of Zagreb…), and some have so far released only one or two reports (Agrokor; Banco Popolare Croatia; Dukat; Farmal; Hauska & Partner; HEP; Croatian Telecom; Adriatic Galenical Laboratory, Stone Sirač; The Bank of Zagreb; Zagreb Airport) in the last ten years.

Among 72 different reports presented by HR PSOR, the most commonly used term is "Report of Sustainable Development"(34,7%) followed by the term "Sustainability Report" (22,2%). In previous years the term "Environmental protection report" (15,3%) was used, and in recent years the terms "Report on socially responsible business"(9,7%) or "Corporate Social Responsibility" (6,9%) are becoming more popular. Significantly less in use appear terms "Social report (4,2%), "Annual Report" (4,2), "Sustainability and social responsibility report" (1,4%) or "Progress Report" (1,4%) (http://www.hrpsor.hr).

Regardless to the name of the report, special attention is paid to issues of environmental protection, often referring to ISO 14000ff certification standards, following the national environmental policy (waste, water, CO_2 emissions, gas emissions..) and National Sustainable Development Strategy (SSDC 2009; OG 110/07). This information is also connected with the provisions of the Environmental Protection and Energy Efficiency Fund of the Republic of Croatia (OG 107/2003), structured as an extra-budgetary fund which finances projects and activities in three basic areas: environmental protection, energy efficiency, and the use of renewable energy sources.

The important part of reports' content is focused on labor and human rights, employee's satisfaction and education, community involvement and development, organizational governance, as well as communication with the consumers and suppliers in order to be provided with sustainable products and services. Human rights are very important issue in the sustainability and social responsibility report, and in the last years the problem of stress increase at work is highly considered. The companies are trying to be more and more engaged in local communities, by financially supporting local sports clubs, humanitarian projects and activities guided by NGOs or other stakeholders. Orientation on sustainable products and services is also presented in reports, following trends and orientation of the EU and specific needs of particular industries. The frequency and content of items in sustainability reports is presented in table 1, according to the analysis of 11 sustainability reports of Croatian companies, published in the last three years (1) Agrokor; (2) Highway Rijeka-Zagreb; (3) Banco Popolare Croatia; (4) Carlsberg Croatia; (5) Dukat; (6) Hartman Croatia; (7) Holcim; (8) Telecom Croatia; (9) Adriatic Galenic Laboratory; (10) Končar and (11) Pliva - http://www.hrpsor.hr).

GRI - SUSTAINABILITY PERFORMANCE INDICATORS	Companies in Croatia that disclose sustainability reports*										
	1	2	3	4	5	6	7	8	9	10	11
ECONOMIC PERFORMANCE INDICATORS											
ECONOMIC PERFORMANCE											
EC_1 Direct economic value generated and distributed, including revenues, operating costs, employee compensation, donations and other community investments, retained earnings and payments to capital	X	X	X			X	X	X	X		X
climate change	X		X			X		X		X	
EC_3 Coverage of the organization's defined benefit plan obligations	X		X			X		X			
EC_4 Significant financial assistance received from government	X		X			X		X			
MARKET PRESENCE											
EC_5 Range of ratios of standard entry level wage compared to local minimum wage at significant locations of operation			X					X		X	
EC_6 Policy, practices, and proportion of spending on locally-base suppliers at significant locations of operation	X		X			X		X			
EC_7 Procedures for local hiring and proportion of senior management hired from the local community at locations of significant operation	X		X			X		X		X	
INDIRECT ECONOMIC IMPACTS											
EC_8 Development and impact of infrastructure investments and services provided primarily for public benefit through commercial, in-kind or pro bono engagement			X			X		X			
EC_9 Understanding and describing significant indirect economic impacts, including the extent of impacts			X			X		X			
ENVIRONMENTAL PEFRORMANCE INDICATORS											
MATERIALS											
EN_1 Materials used by weight or volume	X		X			X		X			
EN_2 Percentage of materials used that are recycled input materials	X		X			X	X	X			
ENERGY											
EN_3 Direct energy consumption by primary energy source	X	X	X	X	X	X	X	X	X		X
EN_4 Indirect energy consumption by primary source	X	X	X			X		X			X
EN_5 Energy saved due to conservation and efficiency improvements			X			X		X			
EN_6 Initiatives to provide energy-efficient or renewable energy based products and services, and reductions in energy requirements as a result of these initiatives			X			X		X		X	
EN_7 Initiatives to reduce indirect energy consumption and reductions achieved			X			X		X			

WATER											
EN8 Total water withdrawal by source	X		X	X	X	X	X	X	X		X
EN9 Water sources significantly affected by withdrawal of water			X			X		X			X
EN10 Percentage and total volume of water recycled and reused						X		X			
BIODIVERSITY											
EN11 Location and size of land owned, leased, managed in, or adjacent to, protected areas and areas of high biodiversity value outside protected areas	X	X				X		X		X	
EN12 Description of significant impacts of activities products and services on biodiversity in protected areas and areas of high biodiversity value outside protected areas	X	X				X		X		X	
EN13 Habitats protected or restored		X				X		X			
EN14 Strategies, current actions, and future plans for managing impacts on biodiversity		X				X	X	X			
EN15 Number of IUCN Red List species and national conservation list species with habitats in areas affected by operations, by level of extinction risk		X				X		X			
EMISSIONS,EFFLUENTS, WASTE											
EN16 Total direct and indirect greenhouse gas emissions by weight	X			X		X	X	X			X
EN17 Other relevant indirect greenhouse gas emissions by weight	X					X		X			X
EN18 Initiatives to reduce greenhouse gas emissions and reductions achieved					X	X	X	X			
EN19 Emissions of ozone-depleting substances by weight	X					X		X			
EN20 NO,SO and other significant air emissions by type and weight	X				X	X	X	X			X
EN21 Total water discharge by quality and destination	X				X	X	X	X			X
EN22 Total weight of waste by type and disposal method	X	X	X	X	X	X		X	X		X
EN23 Total number and volume of significant spills	X					X		X			
EN24 Weight of transported, imported, exported or treated waste deemed hazardous under the terms of the Basel Convention Annex I, II, III and VIII, and percentage of transported waste shipped internationally						X		X			X
EN25 Identity, size, protected status and biodiversity value of water bodies and related habitats significantly affected by the reporting organization's discharges of water und runoff						X		X			
PRODUCTS & SERVICES											
EN26 Initiatives to mitigate environmental impacts of products and services, and extant of impact mitigation	X	X		X		X		X	X	X	X
EN27 Percentage of products sold in their packaging materials that are reclaimed by category	X					X		X		X	
COMPLIANCE											
EN28 Monetary value of significant fines and total number of non-monetary sanctions for non-compliance with environmental laws and regulations	X	X			X	X		X		X	
TRANSPORT											
EN29 Significant environmental impacts of transporting products and other goods and materials used for the organization's operations, and transporting members of the workforce	X					X		X			
OVERALL						X					
EN30 Total environmental protection expenditures and investments by type	X	X						X	X		X
SOCIAL PEFORMANCE INDICATORS											
LABOR PRACTICES AND DECENT WORK PERFORMANCE INDICATORS											
EMPLOYMENT											
LA1 Total workforce by employment type, employment contract, and region	X	X	X			X	X	X	X		X
LA2 Total number and rate of employee turnover by age group, gender and region	X	X	X			X	X	X	X	X	X
LA3 Benefits provided to full-time employees that are not provided to temporary or par-time employees,	X		X			X		X			X
LABOR / MANAGEMENT RELATIONS											
LA4 Percentage of employees covered by collective bargaining agreements	X					X		X		X	
collective agreements						X		X			
OCCUPATIONAL HEALTH AND SAFETY											
LA6 Percentage of total workforce represented in formal joint management-worker health and safety committees that help monitor and advise on occupational health and safety programs						X		X			X
fatalities by region	X	X	X			X	X	X	X		X
LA8 Education, training, counselling, prevention and risk-control programs in place to assist workforce members, their families or community members regarding serious diseases	X	X	X			X		X		X	X
LA9 Health and safety topics covered in formal agreements with trade unions	X	X		X		X		X		X	

TRAINING AND EDUCTION											
LA10 Average hours of training per year per employee by employee category	X	X	X			X	X	X	X		X
LA11 Programs for skills management and lifelong learning that support the continued employability of employees and assist them in managing career endings			X	X		X		X	X		X
LA12 Percentage of employees receiving regular performance and career development reviews						X		X	X		
DIVERSITY AND EQUAL OPPORTUNITIY											
LA13 Composition of governance bodies and breakdown of employees per category according to gender, age group, minority group membership and other indicators of diversity	X	X	X			X	X	X	X	X	X
LA14 Ratio of basic salary of men to women by employee category	X					X		X		X	
HUMAN RIGHTS PERFORMANCE INDICATORS											
INVESTMENT AND PROCUREMENT PRACTICES											
HR1 Percentage and total number of significant investment agreements that include human rights clauses or that have undergone human rights screening						X		X			
and actions taken						X	X	X			
HR3 Total hours of employee training on policies and procedures concerning aspects of human rights that are relevant to operations, including the percentage of employees trained						X	X	X			
NON DISCIRIMINATION											
HR4 Total number of incidents of discrimination and actions taken			X			X	X	X		X	X
FREEDOM OF ASSOCIATION AND COLLECTIVE BARGAINNG											
HR5 Operations identified in which the right to exercise freedom of association and collective bargaining may be at significant risk, and actions taken to support these rights	X		X			X	X	X		X	
CHILD LABOR											
HR6 Operations identified as having significant risk for incidents of child labour and measures taken to contribute to the elimination of child labour			X			X	X	X		X	
FORCED AND COMPULSORY LABOR											
HR7 Operations identified as having significant risk for incidents of forced or compulsory labour and measures to contribute to the elimination of forced or compulsory labour			X			X	X	X		X	
SECURITY PRACTICES											
HR8 Percentage of security personnel trained in the organization's policies or procedure concerning aspects of human rights that are relevant to operations								X			
INDIGENOUS RIGHTS											
HR9 Total number of incidents of violations involving rights of indigenous people and actions taken								X			
impact assessments								X			
HR 11 number of grievances related to human rights filed, addressed and resolved through formal								X			
SOCIAETY PERFORMANCE INDICATORS											
COMMUNITY											
SO1 Nature, scope and effectiveness of any programs and practices that assess and mange the impacts of operations on communities, including entering, operating and existing				X		X	X	X			X
CORRUPTION											
SO2 Percentage and total number of business units analysed for risks related to corruption		X				X		X		X	
SO3 Percentage of employees trained in organization's anti-corruption policies and procedures						X		X		X	
SO4 ACTIONS TAKEN IN RESPONSE TO INCIDENTS OF CORRPTION						X		X		X	
PUBLIC POLICY											
SO5 Public policy positions and participation in public policy development and lobbying	X					X		X		X	X
SO6 Total value of financial and in-kind contributions to political parties, politicians and related institutions by country						X		X		X	
ANTI-COMPETITIVE BEHAVIOUR											
SO7 Total number of legal actions for anti-competitive behaviour, anti-trust and monopoly practices and their outcomes						X		X			
COMPLIANCE											
SO8 Monetary value of significant fines and total number of non-monetary sanctions for non-compliance with lows and regulations	X	X				X		X			

SOCIAETY PERFORMANCE INDICATORS											
COMMUNITY											
SO1 Nature, scope and effectiveness of any programs and practices that assess and mange the impacts of operations on communities, including entering, operating and existing				X		X	X	X			X
CORRUPTION											
SO2 Percentage and total number of business units analysed for risks related to corruption		X				X		X		X	
SO3 Percentage of employees trained in organization's anti-corruption policies and procedures						X		X		X	
SO4 ACTIONS TAKEN IN RESPONSE TO INCIDENTS OF CORRPTION						X		X		X	
PUBLIC POLICY											
SO5 Public policy positions and participation in public policy development and lobbying	X					X		X		X	X
SO6 Total value of financial and in-kind contributions to political parties, politicians and related institutions by country						X		X		X	
ANTI-COMPETITIVE BEHAVIOUR											
SO7 Total number of legal actions for anti-competitive behaviour, anti-trust and monopoly practices and their outcomes						X		X			
COMPLIANCE											
SO8 Monetary value of significant fines and total number of non-monetary sanctions for non-compliance with lows and regulations	X	X				X		X			
PRODUCTS RESPONSIBILITY PERFORMANCE INDICATORS											
CUSTOMER HEALTH AND SAFETY											
PR1 Life cycle stages in which health and safety impacts of products and services are assessed for improvement and percentage of significant products and services categories subject to such procedures	X	X				X	X	X	X		X
PR2 Total number of incidents of non-compliance with regulations and voluntary codes concerning health and safety impacts of products and services during their life cycle by type of outcomes	X					X		X			
PRODUCT AND SERVICE LABELING							X				
PR3 Type of product and service information required by procedures and percentage of significant products and services subject to such information requirements	X		X			X		X	X		X
PR4 Total number of incidents of non-compliance with regulations and voluntary codes concerning product and service information and labelling by type of outcomes	X		X			X		X			
PR5 Practices related to customer satisfaction including results of surveys measuring customer	X		X			X		X	X		
MARKETING SOMMUNICATIONS											
PR6 Program for adherence to laws, standards, and voluntary codes related to marketing communications, including advertising, promotion and sponsorship	X		X	X		X		X			X
PR7 Total number of incidents of non-compliance with regulations and voluntary codes concerning marketing communications, including advertising, promotion and sponsorship by type of outcomes	X		X			X		X			
CUSTOMER PRIVACY											
PR8 Total number of substantiated complaints regarding breaches of customer privacy and losses of customer data			X			X		X			
COMPLIANCE											
PR9 Monetary value of significant fines for non-compliance with laws and regulations concerning the provision and use of producers and services			X					X			

LEGEND*: (1) **AGROKOR**; (2) **HIGHWAY RIJEKA-ZAGREB**; (3) **BANCO POPOLARE CRATIA**; (4) **CARLSBERG CROATIA**; (5) **DUKAT**; (6) **HARTMAN CROATIA**; (7) **HOLCIM**; (8) **TELECOM CROATIA**; (9) **ADRIATIC GALENIC LABORATORY**; (10) **KONČAR** (11) **PLIVA**

Source: Prepared by authors on the basis of GRI 3.1., and content of sustainability reports presented on http:/www.hrpsor.hr/hrpsor/indeks-php/hr/izvjestavanje/popis-izvjesca; (access 14.5.2013.)

Table 1: Content and frequency of items disclosed in the sustainability reports of Croatian companies in the last three years based on the GRI 3.1.

It should be noted that for the last three years only about 5% of listed companies in Croatia (11 of 206) disclose their sustainability report for public use on the web pages of HRPSOR (http://www.hrpsor.hr). It can be concluded that this type of information is primarily oriented to satisfy formality, and not to be really involved in the process of achieving the goals of sustainable development presented in National Sustainable Development Strategy. Some activities of The Croatian Business Council for Sustainable Development indicate that improvements can be expected especially through the use of CSR Index to rank companies based on their non-financial impacts and provide input to the environmental legislation throughout the business sector.

Unfortunately, none of the analysed companies that present their reports on the HR PSOR website belongs to the hospitality industry (http://www.hrpsor.hr). It is not in accordance with the possibilities of companies in the hospitality industry, because research results (conducted by authors on the sample of 199 four- and five-stars hotels of Croatian largest hotel companies), indicate that managers are involved in the process of environmental improvement and protection (Janković, Peršić, Zanini-Gavranić, 2012) and introduce sustainability principles (Peršić,M. Janković,S., Bakija,K, Poldrugovac,K. 2013) that are presented in the following table.

Tools and sources of environmental data	Accommo-dation (lodging service)	Food and beverage preparation service	Food and beverage sales service	Other hotel services	Non-commercial and administrative services
	%	%	%	%	%
Reports / statements	**73**	**73**	**64**	**64**	**9**
Questionnaire	**73**	**73**	**64**	**27**	**9**
Budget	**73**	**73**	**64**	**27**	**9**
Environmental protection program	73	73	27	55	9
Surveys conducted by travel agencies	73	-	-	-	-
Eco - use of bed linens	73	-	-	-	-
Check list of the different departments	69	73	64	27	9
Records of waste separation	64	82	64	-	-
Hotel journal	64	-	-	-	-
Statistics	36	73	64	64	9
Service-express	18	27	18	18	9
Procedures (room service, mini bar..)	-	-	73	18	9
Information of safety	-	45	64	-	-
Programs for guests (animation…)	-	-	55	36	9
Waste grease disposal program	-	73	-	-	-
Research of suppliers	-	36	-	-	-
Procedures for hotel operations	-	-	-	-	-

Source: Prepared by authors, based on previous research results

Table 2: Sources of information for sustainable reporting in Croatian hotels

The main reason for applying the principles of sustainable development is to increase their reputation in the eyes of their business partners (100%), loyalty of employees (85%) and provide a competitive advantage to attract investors (67%). The most commonly used sources for financial data in practice are segment reports, as well as budgets, both prepared using same set of rules and supported by specific software. At the same time the Questionnaire is the main source for non-financial data.

4. Sustainability reporting in hospitality industry

The hospitality industry has been affected by both the world-wide growth in tourism and the economic recession. In accordance with these changes, hospitality management accounting is of particular importance as a tool for maximizing revenue and minimizing costs and it has been attractive research area. However, many researchers emphasise that the hotel industry lacks properly developed performance measurement system that could provide useful information for short and long term decision-making, and some of them offer a specific model for the hospitality industry. The orientation towards traditional financial measures and slow adjustment to modern trends are very often stressed (Banker et al., 2000; Mia & Patiar, 2001; Brander Brown & Aktinson 2001; Pavlatos & Paggios, 2009). Limited research has been done in the field of hospitality accounting for the needs of sustainability reporting in the hospitality industry (Mihalič et al., 2011).

4.1. Standards for internal reporting in hospitality industry

Regarding the development of management accounting in the hospitality industry, it can be argued that research and development lags behind in comparison to other industry sectors. The existence of Uniform System of Accounts for the Lodging Industry (USALI, 11th edition, 2014) plays an important role in hospitality performance measurement. It enables the widespread use of a standard chart and ensures competitive benchmarking. USALI has resulted in the development of common approaches to ratios and key statistics. According to Geller's research (1985) the most commonly used performance measures by US hotel companies are operational and financial measures. Similar research carried out in the UK displays almost the same results. Furthermore, CIMA's study (Collier and Gregory 1995) showed interesting findings. The most common way of measuring performance is by comparing actual with budgeted figures. Among traditional measures such as room yield, profit contribution, occupancy rates and labour cost percentage, some ways of quality measures were remarked. Brander Brown and Atkinson (2001) in their research indicate the predominance of financial and past orientated measures. Atkinson (2006) also noted it their research that not much progress has been done and little evidence exist on the development of new theories. Recent research shows that non-financial measures are being included, especially in the field of corporate social responsibility and corporate environmental responsibility (Mihalič et al., 2012).

Uniform System of Accounts for the Lodging Industry (USALI) presents information on the level of responsibility profit center (revenue, costs and internal results) of all accommodation activities (Schedule 1 - Rooms), food and beverage activities (Schedule 2 - Food and Beverage), sum of market-recognized other hotel services (Schedule 3 - Other Operated Departments) and Miscellaneous Income (Schedule 4) It also presents ten (5 - 14) schedules for cost centers (Administrative and General; Information and Telecommunications System; Sales and Marketing; Property Operation and Maintenance; Utilities; Management Fees; Non operating Income and Expenses; House Laundry, Staff Dining, Payroll-Related Expenses) and enables comparison among hotels. (USALI, 2014).

The authors have been conducting this research in the Croatian hospitality industry, systematically in the last 15 years, and conclude that USALI standards have been successfully implemented and reporting results improved (Peršić, Poldrugovac, Janković, 2012). At the same time, sufficient degree of harmonization among operating statements based on USALI standards and information disclosed in the notes to the financial statements have not been achieved. Thus, only a smaller number of Croatian hotel companies disclose information on their segments (mostly for two – room, food and beverage) in the Notes to financial statements which is narrower than the possibility of USALI standard framework (CFA, 2013).

It actually opens up the need for supplementing internal reporting system with new reports which will contain relevant information on acquired level of environment care and achieved goals of sustainable development, based on the standards ISO 14000ff and Global Reporting Initiative 3.1. This would provide the starting point for decision making in the field of environmental protection and relations to the community, in a way to ensure uniform system of information from segment to the national level. This would enable the presentation of internally achieved results to external users, in accordance with standards, different requirements, national and regional regulations.

Managers need this type of information to guide their actions towards achieving sustainable development goals, and these requirements, should adjust accounting information system as well as reporting system for internal and external users (Banker, Potter, Srinivasan, 2000; Brander Brown, 1995; Mia, Patiar, 2001; Philips 1999; Oavlatos, Paggios, 2009). In this way it is necessary to conduct specific research to indicate the connectivity of USALI and IFRS 8 standard with the management requirements as well as external users, necessary for the quality of business decisions making and to be able to evaluate the improvement in the relationship to the environment and community.

This approach pointed out the possibility of using proven accounting tools in order to present information for decision making, which besides economic views of development includes also the ethical way of thinking. In the process of business decision-making environmental and sustainability information can no longer be ignored, because of their great importance in the long-term impact on business success. The quality of decisions made is as strong as the weakest element in the global company information system, which should be fully compliant with the requirements of internal (management) and external users (stakeholders) of information for which environmental conditions should be included in companies' operations.

4.2. Sustainability reporting in hospitality industry

Hotel companies are initiating programs for the implementation of sustainable development into their business. However, the success of such programs will depend on the extent to which national governments encourage sustainable tourism initiatives and their ability to understand how policy impacts the hospitality industry as a whole (UNEP, 2002, p.33-42). Hospitality business influences the environment, economies and society in both positive and negative ways. Today most hotel companies strive towards sustainability, in a manner to manage resources in such a way that economic, social and environmental benefits are maximized both in meeting the needs of the present generation and protecting and enhancing opportunities for future generations (Sloan, Legrand, Chen, 2009).

Previous research has shown that hotels do report about sustainability, but the area of sustainability reporting that seemed to be lacking was environmental (Holcomb, Upchurch and Okumus, 2007). Han, Hsu, Lee and Sheu argue that eco-friendly attitudes favourably affect hotel guests' intentions to visit a green hotel, to spread positive word-of-mouth, and to pay more. Respectively, more efforts must be made to communicate green hotel practices to the public in order to assist the selection of green hotels and more active participation for green consumption (Han, Hsu, Lee and Sheu, 2011). As a strategic vehicle for pursuing social and environmental agenda in hospitality industry the triple bottom line framework is proposed (Hong Chung and Parker, 2011). Implementing an environmental management system would make a good starting point, because the existence of ISO 14001 certified environmental management system determines the entities to report voluntarily information related to environmental performance (Ienciu, 2012). Recommendations for future environmental reporting are making data being communicated to stakeholders more transparent (Legrand, Huegel and Sloan, 2013).

Since 1992, the trend in the hospitality and tourism industry has been on focusing on environmental concerns, use of technology, and efficient use of energy (Kalisch, 2002). This emphasis was escalated to an international scale through the implementation of Agenda 21. Agenda 21 as forwarded by the World Travel and Tourism Council (WTTC), the World Tourism Organization (WTO), and the Earth Council set international guidelines relative to sustainable tourism. The WTO established the Global Code of Ethics for Tourism (GCET), which is a "comprehensive set of ten principles whose purpose is to guide stakeholders in tourism development" (World Tourism Organization, 2005).

The consumption of energy from non-renewable resources, the consumption of drinking water, as well as the amount of solid waste and waste waters are the biggest generators of environmental costs in hotels. The International Federation of Accountants, therefore, proposes the implementation of relatively simple and inexpensive measures to achieve savings - implementation of systematic monitoring and the control of resource consumption, investment in equipment and plant of lower-energy class and investment in recycling systems (IFAC, 2011).

The Green Globe 21 is a global sustainability benchmarking program designed specifically for achieving the sustainability goals and efforts in tourism and hotel industry (Green Globe 21, 2004). It offers a series of carefully chosen key performance indicators connected to the reduction of carbon emissions, energy efficiency, air quality protection, noise control, fresh water resource management, wastewater management, waste minimization, improved social and cultural relations, land management and ecosystem conservation and management. Declining resources, radical transparency and increasing expectations (Laszlo, Zhexembayeva, 2011) should be interconnected in the hotel business strategies if we want to embed sustainability into practice. The general approach of sustainability should be adjusted to the specifics of the real circumstances of a particular hotel or hotel company to answer to the following questions (Johnson, A. et al. 2003, 17):

- o Which natural resources and services are used to produce and offer target product and services? How should the costs and benefits of resource use be measured?
- o How integrated are energy, motivation, knowledge, capacity for relationships, and other forms of human capital? What types of and how much direct and indirect value does integration create?
- o How do the tourism products and services create value for local individuals, social groups and their relationships, and how can this be measured?
- o Can existing manufactured stock and infrastructure be used in way that requires fewer resources and more human creativity? Can these efficiencies and their value be measured?
- o Can sustainable business practices be used to create or increase value for a hotel's or hotel company's stakeholders?

Well-organized management information system and sustainability accounting play a particularly important role in the process of manager decision-making, focused on the achievement of sustainable development goals in hotels and hotel companies.

Global Reporting Initiative made a comprehensive framework with detailed explanations about the components of economic, environmental and social pillar. (GRI, 2013)

Economic category covers aspects of economic performance, market presence, indirect economic impacts and procurement practices. Economic performance discloses generated and distributed value like revenues and different costs by hotel departments (room, food and beverage, sport, wellness, other operating departments…). From normalized metrics usually is used revenue per available room (RevPAR), average room rate (ADR), division revenue per guest or m2, or daily average meal check. (Wadongo, Odhuno, Kambona & Othuon, 2010).

Environmental indicators represent diverse impacts that a hotel company has on the environment. Subcategories can be divided into materials, energy, water, biodiversity, emissions, effluents and waste, compliance, overall, supplier environmental assessment and grievance mechanisms. Materials are devised on renewables and nonrenewables and are disclosed as paper or cleaning material consumption per room or per guest. Energy consumption can be measured as total or divided by energy sources and is disclosed by room or guest. Regarding the water consumption, it is important to measure percentage of recycled water and percentage of water reduction consumption. Water consumption is usually also shown per room or guest. Within biodiversity the variety of species has to be recorded and the issues that can have influence on them. Potential indicators for measurement are number of protected habitats, number of species or number of planted plants that are adapted to a particular environment.

Emissions include measuring direct and indirect greenhouse emissions, noise and dust emissions, indoor air quality as well as reduction in emissions. Effluents and waste can be divided by type, on hazardous and non-hazardous that is by the disposal methods or whether it is recyclable or non-recyclable. Compliance category comprises issues that arose while the company didn't respect laws, regulations or standards. It can be measured in number of fines or total cost of fines. Overall category includes costs that are associated with environmental aspects like cost of investment in environmental protection or prevention costs, cost of waste treatment and remediation costs. Supplier environmental assessment category addresses suppliers that have been screened according to some environmental criteria. Different measures can be applied such as number or percentage of suppliers that have environmental management certificates or number of suppliers that deliver organic-certified food or similar. Category environmental grievance represents negative environmental actions that have been reported and resolved (GRI, 2013). All this environmental categories are usually reported by guest or rooms, or by overnights or employee.

Social category is associated with all aspects that influence social system within and outside the company and can be divided in labor practices, human rights, society and product responsibility. Labor category addresses employee and supplier related aspects from employment, training, health and safety to equal opportunities. Human rights category addresses discrimination, oppressions, child and forced labor, freedom of association and can be measured by number of implemented policies, number of actions undertaken and cost of training. Society category can be quantified as number of cooperation's with municipality and local residents, community satisfaction, value of political donations, number of incidents of corruption, cost of fines for non-compliance with laws, regulations and standards, number of screened suppliers according to some social criteria. Last category product responsibility includes guest satisfaction scores, overall or divided by different groups like satisfaction with employees, facilities, benefits gained, value for money or number of returning guests, number of customer complaints or similar.

5. Conclusion

Contemporary trends in the hotel industry force hotels on changes in their business policy and strategy. Those changes are necessary for implementing sustainability reporting.

For improving the hospitality accounting and adopt to sustainability reporting systems it would be useful to upgrade the well-developed financial reporting system, based on the USALI - Uniform System of Accounts for the Lodging Industry standards, that are compatible with the starting points of IFRS 8, and integrated with the GRI Indicators. The same principles can follow the process of sustainability reporting systems in hotel companies, which will be designed in such a way to highlight the competitive advantage of the hotel company. By using relevant indicators, a possibility of benchmarking within the global hotel industry will be ensured, with a tendency to apply the same assumptions for the other branches. Sustainability accounting has to be established on specific management requirements in order to be a relevant source of decision-making information for evaluating sustainability performance in the specific condition of a particular hotel company.

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