

**Sixth Bosnian Herzegovinian, Croatian and Turkish Jurist Days**

# **THE LEGAL FRAMEWORK FOR ECONOMIC COMPETITIVENESS**

**Zagreb, 19-23 April 2017**

**CONFERENCE PROCEEDINGS**

**Sixth Bosnian Herzegovinian, Croatian  
and Turkish Jurist Days**

**THE LEGAL FRAMEWORK  
FOR ECONOMIC  
COMPETITIVENESS**

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## INTRODUCTION

The Faculty of Law, University of Zagreb was honoured to host The 6th Bosnian Herzegovinian-Croatian-Turkish Jurist Days from 19th to 23rd April 2017. The topic of the Conference was „The Legal Framework for Economic Competitiveness“. This annual conference has been a result of continuous cooperation of the academics from the Sarajevo, Istanbul and Zagreb law schools. At the Zagreb conference, professors from the law faculties of Sarajevo, Istanbul and Zagreb presented and discussed their papers at four panels: law and economics, criminal and administrative law, commercial law, labour and financial law. The Zagreb conference hosted more than thirty presenters and over twenty papers were discussed. This volume includes the submitted papers that were carefully selected and improved based on the comments and suggestions of the esteemed international reviewers. All papers published in the Proceedings have passed a double-blind review process.

The participants believe that the trilateral conference held in Zagreb, much like the previous ones, emphasised a multidisciplinary and interdisciplinary approach while covering a wide range of relevant and up-to-date issues related to the main topic. Moreover, every year our trilateral conferences contribute to the exchange of empirical and theoretical insights, experiences and opinions, and stimulate productive discussions. In line with that, the papers presented in this book should demonstrate the diversity and similarities between participating countries and inspire authors and readers to carry out new (comparative) research.

I hope that this book will encourage further fruitful cooperation between the faculties of law of the University of Istanbul, the University of Sarajevo and the University of Zagreb.

Ružica Šimić Banović, PhD

Editor

## COMPETITIVENESS AND TAX REFORMS – FRIENDS OR FOES?

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### SUMMARY

*This paper deals with the impact the key taxes exert on competitiveness in Croatia. The aim of the paper is to expose and analyse the main features of those taxes (corporate income tax, value added tax and personal income tax) and how and to what extent they influence Croatia's competitiveness. The hypothesis is that two features of the tax system influence the competitive ability of the country: complexity, often unnecessary and harmful, and the often biased tax administration approach towards taxpayers. Researching the subject, the authors employed different methods: normative analysis, historical approach, comparative method. The conclusion is that both features stressed in the hypothesis indeed do negatively influence the competitiveness of the Croatian economy to certain, not negligible extent.*

*Key words: competitiveness, tax, tax reform, corporate income tax, value added tax, personal income tax, tax administration*

### INTRODUCTION

The competitiveness, and its derivative, competition, is perceived as a good thing (at least as far as capitalism is concerned); in the private sector, upgrading competitiveness is by definition a good thing. Furthermore, if there were no state, no public sector, and, consequently, no taxation, competitiveness would by all means be all good.

However, in the real world, there is a public sector and there is taxation. When it comes to the public sector and its aims, achieved through the taxation as a financial means, competitiveness is often viewed as closely connected to the tax competition between different countries and their tax systems. So the question is whether tax competition a good thing, or should the countries strive to accomplish tax harmonization by unifying their tax systems and creating an internationally neutral tax environment.

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There are some pro tax harmonization arguments, as well as some pro tax competition arguments.

Reduction of compliance costs, transparency for the taxpayer, tax neutrality in order to further the optimal allocation of resources and to support individual and international equity of taxation, and redistributive effects of taxation are often cited as pro tax harmonization arguments.

Pro tax competition arguments would be downward pressure on tax burden, fiscal discipline, proper balance of tax level and public goods.

In the context of Croatia, competitiveness policy is unclear, if existent at all, and tax solutions do not contribute to its clarity. According to one research, Croatia ranked 74 out of 138 countries regarding the competitiveness criteria in the 2016-2017 period (Schwab, 2017). In our research, and relative to the length of the paper, we try to expose and analyse Croatia's taxes that chiefly influence the country's competitiveness, whether policymakers are aiming at that influence or not; taxes, namely, do impact competitiveness, even if the said policymakers ignore them as such.

The aim of the paper is to explore the main features of the Croatian tax system, i.e., of its key taxes, regarding the impact of those taxes on the country's competitive ability. Our hypothesis is that the Croatian tax system, mirrored in its main taxes, is complex *per se*, and that that complexity, although in some elements understandable, hinders the country's competitiveness. Further, Croatian tax administration's approach to taxpayers is biased, non-neutral and harmful for the country's competitiveness.

The research methods used in this paper are the analysis of the laws in force, as well as historical approach, i.e. the analysis of some past solutions and their impact on entrepreneurs and their ability to compete. The comparative method was also used while comparing taxes as the subjects of research.

This paper consists of five parts, with the first and the fifth respectively as the introduction and the conclusion. In the rest of the paper we analyse major Croatian taxes in view of their impact on the competitiveness of Croatian economy. Those taxes are corporate income tax, value added tax and individual income tax. The second part deals with corporate income tax (profit tax), its main features and carrying out a critical analysis concerning its influence on competitiveness. The same approach is present in the third part, dealing with value added tax, and in the fourth part, referring

to personal income tax. The fifth part is the conclusion, summing up the authors' findings and confirming their hypothesis.

## **1. CORPORATE INCOME TAX**

Pursuing the aim to attract foreign investors and their capital with fiscal instruments, governments mostly use corporate taxation. This is also applicable to the Croatian corporate income tax system, which is very often the source of various allowances, exemptions, deferrals and rate relieves. The economic explanation for such behaviour lies in the fact that countries that suffer from underdeveloped entrepreneur activity and growth need the inflow of capital and the know-how from abroad to boost national resources. However, tax incentives cannot be used exclusively for such complex goals without the inclusion of other instruments. In addition to business rationales, the size of the market, development of the financial system and many other evaluations based on the anticipation of the company's and country's prospects, taxes are often perceived as having "third-level" importance for the corporate strategic decision-making process<sup>1</sup>. Based on their research on the link between political risk, institutions and foreign direct investment inflows, for which they used a sample of 83 developing countries, Busse and Hefeker (2015) stated that the indicators of the highest importance for the activities of multinational corporations are government stability, the absence of internal conflict and ethnic tensions, basic democratic rights and ensuring law and order. Political risks, including taxation risks, represent the main obstacles for investments in developing countries, due to legal tax uncertainty that characterises business activities in such countries.

These circumstances lead to the paradox of tax incentives and the vicious cycle of tax avoidance on the tax payer side and tax scrutiny on the tax administration side (Bogovac, 2014). Therefore, countries whose primary goal was attracting multinational companies to provide investment, create jobs, foster activity of small and medium enterprises, facilitate transfer of innovations, pay VAT, personal income taxes and contributions, are ultimately left without capital and know-how inflow. The trend of OECD countries lowering corporate tax rates continued during 2016 (OECD, 2017). Throughout the last decades, this trend has resulted in a corporate income tax that is

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<sup>1</sup> This „third-order importance“ originally referred to the priorities in capital structure determination stated by Myers et al. (1998) but was proven and used for investment decisions as well (Hanlon and Heitzman, 2010; Bogovac, 2014).



characterised by the decrease in rates but stable public income at approximately 10 percent of the total tax revenues (IMF, 2017).

Putting all these facts together, we can conclude that Croatia, as many other developing countries suffers from both the shortfall of FDI in spite its necessity, and stark predictions regarding the future of its dormant economy. With the aim to answer the question behind the reasons of the disuse of the generous tax incentives in Croatia, we shall explain two instruments that had been prescribed by law but without effect on Croatian economy: the protective interest rate and allowance for the re-invested profits.

Croatia has a long history of tax incentives prescribed by the Corporate Income Tax Act that were not fully supported by the Government during the implementation phase. At the very beginning of Croatian independence, the tax reform in 1994 was introduced with a protective interest rate, a leading-edge fiscal instrument. The concept of the protective rate was based on the fact that investments in the capital of the company should be equally treated, for the corporate taxation purposes, as loans used for the purpose of financing business. The tax advantages of debt financing were first explained by Modigliani and Miller (1963) and for decades to come tax administrations have tried to find ways to tackle tax avoidance built on this privilege<sup>2</sup>. Additionally, governments have tried to attract investments in capital and re-investments of profits. Implementing the instrument of protective interest enables the user to reach both goals: it is an appropriate model of protection for the substance of the company and it simultaneously discourages repatriation of profits as well as expanding re-investments.

With the aim to recognise the capital expense of an enterprise, protective interest was created as a compound of two components: nominal interest rate and inflation rate. This compound rate had been applied to all capital increases during the tax period, so the effect was similar to the deduction of the interest expenses of the loans: due tax was decreased. It is worth emphasising that this „allowance“ for the taxpayers was obviously not a tax regime of preference for the entrepreneurs investing in the substance of their businesses, but rather the instrument which prevented tax discrimination of the owners who invested in capital and decided to re-invest profits in the business over those who financed their business with debt. Introduced in 1994, this instrument had many opponents and implementation problems so it was finally abolished in 2001 without clear evidence but with the explanation that it was too

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<sup>2</sup> For example, the well-known anti-avoidance measure, the so-called „thin capitalisation rule“.

complicated and decreased the tax base of many taxpayers. Interestingly enough, the taxpayers were not those who were complaining about its complexity and 15 years later we can only conclude that corporate income tax is far from simple and transparent. It seems that the only reason for the abolishment was the demand for more tax revenue, which proves the paradox of this allowance. Introduced with the aim to increase long-term economic growth by sacrificing part of the tax revenue in the short-term, this incentive was recalled without convincing evidence based on the calculations of the costs and benefits it caused in the economy. Simple argumentation on lost revenue can hardly justify the outcome. Still, in the post-communist country with the newly introduced market economy, a country that still suffered from the consequences of the Homeland war, it was the easiest way to demonstrate it.<sup>3</sup>

Re-invested profits, the measure that is very similar in effects to the protective interest rate, is considered more transparent and simpler for both the tax administration and taxpayers. Unfortunately, from the very beginning, this instrument was not perceived as desirable from the standpoint of the tax administration. This can be easily recognised in Art. 6 of the Corporate Income Tax Act<sup>4</sup> written before the abolishment of this incentive, since tax allowance was prescribed by a few simple words and then safeguarded by several paragraphs of limitations, requirements, exclusions and conditions, additionally and broadly specified in the Bylaw<sup>5</sup>. Re-invested profit, for which the tax base might be decreased in the period 2012 to 2016, was defined as “profit of the tax period used for the investments and development that increases the company's capital in accordance with special regulations”. Due to the fact that many taxpayers were not within the scope of the incentive (craftsmen, institutions, associations, financial institutions) and that the incentive was not transparent, the incentive proved to be unattractive to the taxpayer. The Government explained the abolishment of this incentive using the argument that “parallel to the reduction in the tax rate, due to the need to preserve a certain level of revenue from the profit tax, i.e. to ensure fiscal sustainability, the widening of the tax base is proposed” and that “The Investment Promotion Act (Official Gazette No. 102/15) provides for the possibility, depending on the amount of investment in fixed assets and the number of newly created jobs, to pay tax on profits by applying a tax rate of 0% over a period of up to

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<sup>3</sup> This approach of the governments is not exclusively connected with the developing states. The unproblematic public acceptance of arguments that do not seem feasible enough is more likely connected with the less developed countries where the consequences are significantly more powerful.

<sup>4</sup> Official Gazette, 177/04, 90/05, 57/06, 146/08, 80/10, 22/12, 148/13, 143/14, 50/16, consolidated version.

<sup>5</sup> Art. 12.a, Official Gazette, 95/05, 133/07, 156/08, 146/09, 123/10, 137/11, 61/12, 146/12, 160/13, 12/14, 157/14, 137/15, consolidated version.

10 years". Therefore, "the abolition of tax incentives for reinvested earnings cannot negatively affect the development of investments".<sup>6</sup>

The Government consistently presents these arguments without conducting or citing serious studies on the reasons for the lack of usage and popularity of the incentives, previously described as incentives for economic growth. Croatian experiences with tax allowances, explained by these examples, are not isolated patterns of policy makers' behaviour. OECD reported that „virtually every government (and virtually every private researcher) adds to tax expenditure<sup>7</sup> estimates routinely. The reason is that there is no alternative way to compare the prevalence and size of tax expenditures over time and across countries" (OECD, 2010: 152). The problems in calculating the long-term benefits to the economies boosted by these expenditures are even more complicated. In the end, short-term perspectives of politicians should not be ignored. As The Chairwoman of the Council of Economic Advisers in the Obama administration pointed out: „The one thing that has disillusioned me is the discussion of fiscal policy. Policymakers and far too many economists seem to be arguing from ideology rather than evidence" (Romer, 2011).

## **2. VALUE ADDED TAX (VAT)**

VAT is net turnover tax imposed in all phases of procurement, production, distribution and consumption of goods and services. From the technical point of view, it is perfectly shaped so that all taxpayers are involved in the prevention of tax avoidance since the VAT on inputs decreases the VAT payable on the outputs. Therefore, it is in the interest of taxpayers to control that all the received invoices include the calculated VAT, so that every recipient of a VAT invoice verifies the issuer. Techniques of the functioning of VAT, supported by the IT and the communication sector, enable an enormous number of transactions to be documented in real time, facilitating bookkeeping and preparation of VAT returns for the taxpayers, as well as audit and control for the tax administrations.

On the other hand, it is important to mention that, in general, VAT taxpayers are not those who bear the burden of this tax. Taxpayers are mere agents of the state who have

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<sup>6</sup> Ministry of Finance, Nacrt prijedloga zakona o izmjenama i dopunama Zakona o porezu na dobit, Zagreb, November 2016.

<sup>7</sup> Tax expenditures include all types of tax allowances, exemptions, rate relieves, tax deferrals and credits (OECD, 2010: 12).

the obligation to correctly calculate VAT for every taxable transaction, have the right to deduct input VAT after cautious control, and have to submit VAT returns and declare net VAT to be paid (if output VAT is bigger than input VAT) or reclaimed (if input tax is bigger than output tax). This is not only a costly, but also a very risky obligation: in case a mistake is made during any of these comprehensive commitments, VAT taxpayers are made to pay VAT and penalties. Still, if entrepreneurs' business processes are well organised, VAT should not trigger huge risks.

The obligation of the Tax authority to repay VAT that the taxpayer declared at the VAT return was prescribed clearly in the first VAT Law introduced in 1995<sup>8</sup> and this obligation has not changed to this day<sup>9</sup>, though the deadline has been extended to 30 days (or 90 days after a tax audit started).

This tax calculation method ensures that the VAT obligation to pay tax or to reclaim it follows the business performances of the taxpayers in taxable periods: sometimes entrepreneurs have periods during which they sell more goods and perform more services than at other times. Taxpayers sometimes calculate more input VAT than output VAT, while the situation is sometimes reversed. Moreover, this is a perspective of one taxpayer: if we take a distant and general view of the VAT paid and reclaimed, it comes as no surprise that the technique is safeguarded within the budget since VAT can be deducted only if previously paid by the issuer of the invoice.

In accordance with that course of normal business rhythm, reclaiming VAT should not be a shocking event for the tax administration.<sup>10</sup>

Croatian entrepreneurs have been confronted with huge insolvency in the Croatian market and in some markets where they traditionally have business partners (customers). Late payments for the issued invoices, together with the obligation to pay VAT on time, very often cause additional cash problems for them. Anecdotal

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<sup>8</sup> VAT law, Official Gazette no. 47/1995. Art. 21. stipulated that Tax administration has to repay the net amount of the VAT in 15 days. Law applied as of 1<sup>st</sup> January 1998.

<sup>9</sup> VAT law, Official Gazette no. 73/13, 148/13, 143/14, 115/16; *Decision of the Croatian Constitutional Court 153/13*, Art. 66.

<sup>10</sup> This explanation of the functioning of VAT is given in general terms since many situations that require special provisions and schemes exist in business. This is especially the case with tax evasion and tax fraud schemes (e.g. VAT carousel frauds). However, many standpoints presented here can be argued within the concrete schemes due to the fact that the Croatian Tax administration has the possibility to check VAT paid by issuer of the invoice, or paid by the same taxpayer within the reverse-charge scheme.

evidence<sup>11</sup> shows that managers are often forced to take out bank loans in order to pay VAT on time.

On the other hand, VAT that should be repaid from the budget to the taxpayers is often late due to blocking actions of the Tax administration. Taxpayers are often made to wait far longer than the time stipulated by the law, in spite of the facts that: (i) the VAT law clearly prescribes the obligation of the Tax administration to repay the amount of input VAT that is larger than output VAT, (ii) VAT subject to refund is already paid by the issuer of the invoice or by the same taxpayer, and (iii) the Tax administration has enough instruments and reasonable time available to check the specific questionable transactions. At the same time, entrepreneurs do not know when they would receive repayments so they cannot perform their cash management.

In addition to what has been said about the postponements of the repayments of VAT to the taxpayers, anecdotal evidence suggests that the majority of taxpayers in Croatia very rarely have chosen the option to get repayment. They often opt for the deferral of the VAT repayments to the next taxable period when these amounts might be offset with the obligation to pay the net amount of VAT. The reason for such behaviour is very simple: if they decide to get cash into their account, that would immediately trigger a tax audit. Due to the unwillingness to meet tax inspectors in short time<sup>12</sup>, managers choose to further worsen the cash position of their companies. This approach even led to the abandonment of the cumulated rights for VAT repayments since they fall under the statute of limitations clauses.<sup>13</sup>

Another example of entrepreneurship under fiscal scrutiny is the Croatian tourist industry. Even though the share of Croatian international tourism receipts in the GDP amounted to 18.9% in 2015, while the European average amounted to 2.3%<sup>14</sup>, Croatian

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<sup>11</sup> Some opinions and observations given by the author are based on personal experience, and experiences and opinions of the experts from the field. These opinions cannot be supported by the official data or publications about appeals, audits, suits, judicial practises or any other practices of the Tax administration or courts in Croatia or tax returns submitted by the taxpayers, because this information is not publicly available.

<sup>12</sup> This unwillingness is not caused only by the fear of scrutinised examination of the business and bookkeeping, but also by the fact that entrepreneurs have to put additional efforts in serving tax inspectors or/and pay tax advisors to deal with the tax issues and procedures which can easily become too complicated and which they, very often, do not understand.

<sup>13</sup> This was the case with many industries that suffered from the last crisis which started in Croatia in 2009, especially in the construction sector. These taxpayers have been experiencing a drop in sales for years, so they did not have the opportunity to offset their repayment VAT amounts with any output VAT (if they preferred not to have a tax audit).

<sup>14</sup> Croatian Chamber of Economy, Tourism in 2016, Available at: <https://www.hgk.hr/documents/aktualna-tema-turizam-u-20165899d9633ad81.pdf>, 15. 7. 2017. These

Government's VAT measures have not been supportive of this very fragile economic sector. In addition to the revenue directly generated by tourism, the industry is important for the Croatian economy because of the spillover effects: successful tourism has huge positive consequences on retail sales (where additional VAT is paid and collected from the final consumers) and on the investments in real estate. Therefore, while the tax reform was prepared in 2016, professionals working in the tourism sector expected the Ministry of Finance to lower the VAT rate from 13% to 10%. At the end of 2016, the VAT rate for touristic services was raised to 25%. After some negotiations, the previous VAT rate stayed the same for bed and breakfast services, as well as half and full board services.<sup>15</sup>

Nevertheless, the summer of 2017 is breaking records again, and overnight stays have grown by 5.4% in comparison to 2016. Tourist stays have also been extended from 5.2 days to 6.4 days. We can only hope that Croatian tourism is strong enough to overcome this huge tax pressure on prices, and remain competitive in the global market, while persisting as a stable industry in the Croatian economy.

It seems that VAT refunds are more often repaid to taxpayers in recent years, since Croatia has become a member of the European Union. We can expect the position of the taxpayers to improve over time, as harmonisation with the *Acquis communautaire* continues. Honest and business-oriented taxpayers should not suffer from the scrutiny of the Tax administration because of the tax evaders or because of the shortage of tax revenues in the budget. A competitive and business-friendly environment that needs to be developed in Croatia requires entrepreneurs, as taxpayers who recognise their obligations, on one side and the understanding and support from the Government and Tax administration on the other.

### **3. PERSONAL INCOME TAX**

Personal income tax and corporate income tax are the key vehicles many different countries utilise to promote their own competitiveness through investment attraction. The reason is obvious – taxes are always an expenditure, diminishing the income or

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data do not show desirable structure neither for the GDP nor for the public revenues, but the goal of the Government should be to boost other industries within the economy, not to put weight of the public revenues on the industry, which is one of the most important points of support in overcoming economic austerities.

<sup>15</sup> Tatjana Miščančuk, Hina/FaH, Available at the web pages of the Ministry of Tourism: <http://www.mint.hr/default.aspx?id=37937>, 10. 7. 2017.

profit as the net worth stemming from the business activity or employment. Faced with the imperative to collect public revenues, of which the taxes are the most important (including contributions with social aims, in some fiscal systems known as social taxes), and with the need to boost the entrepreneurial climate in order to further the employment and the national wealth in general, contemporary countries use public revenue systems to achieve both goals.

When it comes to taxation, legislators are particularly prone to introducing different built-in tax incentives, that way trying to attract foreign investments, and to possibly activate dormant domestic capital. The question is whether and to what extent does Croatia utilise those instruments. To answer this question, it is necessary to comparatively analyse the laws on income and corporate income tax currently in force in Croatia<sup>16</sup>, notwithstanding the *supra* analysed corporate income tax. In Croatia, the Law on Income Tax<sup>17</sup> (hereinafter: LIT) currently regulates the taxation of income.

Basically, Croatia restrained itself from furthering its economy competitiveness by way of reducing income taxation; it could even be argued that the competitiveness was only of marginal importance in the process of drafting the latest version of the LIT, or that competitiveness had been pushed aside in that process.

### **3.1. Tax treatment of distributed profit**

Up until the 2016 version of LIT, the tax treatment of distributed profit was subject to voluntary changes in Croatia; in fact, it depended on which political structure was in power after the election. Typically, the elected centre-right option was prone to abolish the taxation of the distributed profit, while the centre-left option was introducing, upon taking the office, that taxation. It all changed when the centre-left government introduced dividend taxation in 2012 once again (after it had been abolished in the previous period, under the centre-right government), and the centre-right government kept this approach upon its ascent to power in 2016. Now it seems this taxation is here to stay, at least for a while. Notwithstanding the always present theoretical discussion (but with undoubted practical impact) on the dilemma – taxing dividends or not – this stipulation for Croatia means, generally speaking, a higher tax burden and less profit from investments for investors; it certainly does not contribute to the country's ability

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<sup>16</sup> Tax literature in English regularly uses the term "income" for both individuals and companies. In Croatia, however, the term "income" refers only to individuals, while "profit" refers to the income of companies.

<sup>17</sup> Official Gazette, no. 115/16, in force since 1 January 2017.

to compete internationally, and to activate domestic capital maybe not invested in securities yet.

The present solution remains questionable, since it was not the part of the approach taken at the beginning of the comprehensive Croatian tax reform, started, and largely executed, in 1994, by adopting the first versions of LIT and the Law on Corporate Income Tax. In those Laws, dividends and interest were tax-free income; the goal was to simplify the tax system as much as possible, while at the same time unburdening the income from capital. However, in the period from 1994, this concept underwent gradual dissolving until it was completely abolished.

### **3.2. Capital taxation**

The extent of the capital taxation (within the income tax, as one form of income taxation) is considerably broader in the LIT of 2016. We could only assume that simple, transparent taxation is something desirable, a goal to be achieved; after all, the transparency (along with neutrality) was the proclaimed “new” taxation principle at the beginning of the wave of tax reforms in 1980s. One would expect to see those principles as the leading ones in markets emerging as the Iron Curtain fell, especially once the old tax regimes were swept away during the transition from socialism to market economy. This was indeed the situation in the Republic of Croatia in the years following it proclaiming independence; the tax system which was put in force at the beginning of 1994 was rather transparent and neutral, especially when it came to capital taxation (for distributed profit, see above). Other forms of income in the form of capital, commonly taxed in tax systems with a long time tradition, not subjected to transition, were basically relieved from taxation in Croatia, e.g. interest.

However, various factors influence tax systems, good part of them making it more complex and non-transparent. Some of them are simply legislator’s mistakes, omissions and defaults to tune the tax laws with other laws, and, more often, with each other; some are the consequences of the necessary complexity of tax laws (McCaffery, 1990). So, as far as competitiveness is concerned – why not have simple, transparent tax system, especially when the system itself started with one? That one, certainly, was not perfect; no one is. However, it served the purpose – collecting public revenue, without distorting the competition. Furthermore, it could not be characterized as promoting harmful tax competition, since it included general aspects of tax system, not aiming at tax-privileging some taxpayers at the expense of others.



Nevertheless, it was not meant to last untouched. The way that “retouching” worked in the case of distributed profit has been described above. In the LIT of 1994, there was no tax on income from capital at all; is it not good for competitiveness as such? The legislator’s message is clear – in short, investment (and entrepreneur) friendly. Taxable income was the one earned from employment, from independent personal activities (self-employment), and from property and property rights. It assured the taxation of income realized in market; all the other earnings, stemming from market income were considered taxed through those three kinds and further taxation of those earning would be unjust double taxation.

That concept (i.e. non-taxation of the income from capital) was abandoned in 2001, when taxation of the income from capital was introduced. Ever since, that form of taxing income has been present and expanding; in 2001, the taxable income from capital was regulated in one short article (Art. 26, with four short paragraphs of the LIT of 2000), encompassing only two kinds of earnings (profit distributions and interests, whereat interests on deposits were exempt). In the LIT of 2016, income from capital is defined in a separate chapter (Chapter III), comprising seven articles, generally rather long and, more important, rather complicated. We suppose this is not a very competitive-friendly development; while legislator's intention to tax all the income taxation of which can be justified is understandable<sup>18</sup>, it undermines the transparency principle, sabotaging, along the way, the country’s ability to compete.

### **3.3. Croatia as a tax haven – an attempt.**

In the country's short history of taxation, there has even been an attempt to transform it, tax wise, into a tax haven. According, namely, to the Law on Allocation of Public Revenues to the Republic of Croatia and to the Units of Local Self-Government and on the Tax Rates<sup>19</sup>, the profit tax rate was 40% and taxpayers were defined as legal persons and individuals. However, foreign legal persons, realizing taxable profit, were subject to 50% of that rate, i.e., to the 20% of profit tax. This was, of course, discriminatory to the domestic taxpayers, grossly privileging foreigners only for the fact that they are foreigners generating profit. In short, this was a less than sophisticated attempt to attract direct foreign investments by privileging them with huge tax cuts and crudely discriminating the domestic taxpayers in the process.

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<sup>18</sup> It is the legislative form of the Comprehensive Income Taxation theory.

<sup>19</sup> Zakon o pripadnosti javnih prihoda Republici Hrvatskoj i jedinicama lokalne samouprave i stopama republičkih poreza, "Narodne novine" No. 73/91.

The story did not end there; firstly, it is worth mentioning that the scope of tax, back then, was based on the territoriality principle, i.e., the taxable profit was only the one generated in the territory of the Republic of Croatia. This solution certainly eliminated international double taxation to a great extent. However, a question remains – was such an extent the aim of the then legislator.<sup>20</sup> One should bear in mind that the Croatian tax administration was just emerging and was, therefore, lacking the necessary level of expertise to develop solutions for all the intricacies of such a complex issue which international double taxation is.

Secondly, contrary to the aforementioned territoriality principle, another stipulation allowed foreign legal persons and individuals, having an enterprise registered in the Republic of Croatia but doing business outside Croatia, to pay tax at the rate of 1%.

This is the scheme typical for tax havens; but, of course, it did not work. Croatia was a newly established country, waging the war for the independence, without a currency that was internationally recognized as reliable. The whole situation was vague and unstable, the least desirable characteristics for boosting competitiveness and attracting foreign capital. Cutting tax simply was not enough. Besides, establishing that sort of tax haven certainly was not the way for the new state to affirm itself internationally.

#### **4. CONCLUSION**

In the context of competitiveness of an economy, taxes can be viewed at from at least two approaches. There is a more general one, which considers the question of whether taxes should be used as the competitiveness promoting vehicles at all, and a more specific one, tactical so to speak, dealing with issue of how to utilise them as such vehicle. In the latter approach, evidently, the former question is answered affirmatively; all that is needed are technical details in the design of the specific taxes that should create certain result, leading to a country's greater competitive ability in the international environment.

In this paper, we presented the main features of the key Croatian taxes, considering their impact on Croatia's competitiveness.

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<sup>20</sup> Avoiding international double taxation generally means that a country reduces or even gives up its taxing rights, regarding its fiscal residents and their incomes.

As far as the corporate income tax is considered, it could be said that allowances are the most important when it comes to competitiveness. However, they are more or less useless if there is no tax administration, and even broader community, support. That support, is often missing since entrepreneurs, which should be the chief category benefiting from those allowances, are frequently seen as dishonest and as tax evaders.

For the value added tax, the Croatian tax administration is often very slow when it comes to refund the VAT overpaid by taxpayers. It sounds strange, but it seems that they simply do not understand how VAT works. Other, even stranger, interpretation of the tax administration's behaviour would be that they do not pay overpaid VAT because they deliberately avoid paying it back, considering every VAT paid as *ipso facto* "done deal", as finished affair requiring no further consideration.

Croatian personal income tax appears to be rather complex. From a relatively simple, neutral and transparent tax form excepting the income from capital, the way it was back then in 1994, at the time of its introduction into the Croatian tax system, , it grew constantly (quantitatively speaking), its content becoming more complex with every next change. While some of those changes were justified by the complexity of the issues the tax system has to deal with anyway, others are harder to explain (and, consequently, to justify).

We find our hypothesis confirmed. Croatia's tax administration, in its dealings with taxpayers, is too often biased. Putting the interest of the state budget on the pedestal, it hardly tolerates taxpayers who use tax allowances or the right to refund of overpaid VAT. Adding this taxpayer-unfriendly behaviour to the complexity of the tax system, which can be expected to grow, we conclude that the tax environment ("taxscape"), consisting of the tax system and the tax administration approach to the taxpayers, does not contribute to Croatia's competitiveness. Promoting competitiveness means striving to promote an entrepreneur-friendly climate; taxes are one feature of that climate that cannot be ignored. They certainly are the means of financing public needs; that role of theirs, however, does not mean that they cannot contribute to the legal certainty, e.g. by being as neutral and transparent as possible. Building-in those features would by itself promote competitiveness, let alone using more sophisticated instruments other countries (e.g. Ireland) utilize to achieve that goal.

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## DIRECT TAX REFORM IN THE FEDERATION OF BIH: INFLUENCE OF TAX RATES AND TAX EXPENDITURES ON TAX COMPETITIVENESS

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### SUMMARY

*During the process of transition to a market economy, Bosnia and Herzegovina faced the challenges of the tax system reform. In the previous decade huge steps forward were made regarding the tax law sphere: a system of indirect taxation has been established at state level in 2003, while the system of direct taxation remained regulated on the level of entities. Direct tax reform, personal income tax in the first place and corporate income tax aimed at the introduction of contemporary types of taxes (comprehensive personal income tax) and corporate income tax - in both entities, as well as Brčko District - and tax harmonization, in order to create equal conditions for economic activities, equal tax treatment and elimination of harmful tax competition. Tax expenditures established due social and economic reasons are immanent to personal income tax and corporate income tax in the Federation BiH. The aim of this paper is to answer the question if tax rates and tax expenditures of the Federation BiH in the area of direct taxes contribute to the tax competitiveness.*

**Key words:** Tax expenditures, Tax Reform, Personal Income Tax, Corporate Income Tax, Tax Competitiveness

### INTRODUCTION

In the 1990s, the process of transition from a planned to a market economy, transformation of social ownership into the state ownership, privatization and development of private entrepreneurial initiatives and activities, transition to the multi-party system, the building of democratic institutions and the rule of law in Bosnia and Herzegovina were all taking place in parallel with the reconstruction and recovery of the country from war destruction. The Dayton Peace Agreement was signed on 21 November 1995. First of all, it is a peace treaty, but its Annex 4 became simultaneously the Constitution of Bosnia and Herzegovina. The Constitution of BiH submits monetary policy, customs and foreign trade policy, among others, to the

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jurisdiction of the state, while the fiscal and the tax policy fall within the competence of the entities.

In the two decades the process of economic and socio-political changes and state-building, especially the liberalization of foreign trade and the achievement of economic freedoms<sup>1</sup>, a need has emerged to harmonize the legal framework of economic activities<sup>2</sup>, as well as the tax system within the country.

A number of factors, especially those of a political nature, have affected these processes in Bosnia and Herzegovina. Hence they have been taking place relatively slowly, while

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<sup>1</sup> Fundamental economic freedoms are recognized and guaranteed by International and European conventions and charters as well as by the Constitution of Bosnia and Herzegovina (Article II and Annex I). According to the article I, paragraph 4. of the Constitution of BiH there is freedom of movement of persons, goods, capital and services as a condition for the functioning of a single market. Freedom of movement and residence implies the freedom of establishment of legal entities, and the competence for regulating the legal status of economic entities of a private-legal character under the provisions of the Constitution belongs to the entities. The Preamble of the Constitution of BiH, paragraph 4, pointed out a commitment to encourage general well-being and economic development through the protection of private property and the improvement of market economy. [http://www.parlamentfbih.gov.ba/bos/parlament/o\\_parlamentu/ustavbh.html](http://www.parlamentfbih.gov.ba/bos/parlament/o_parlamentu/ustavbh.html); Freedom of movement of people and capital, market economy and entrepreneurship as the basis for economic regulation of the country are also guaranteed by the Constitution of Federation of Bosnia and Herzegovina (see: Trnka; 2014, 17). In the context of creating a more favorable climate for the business on one hand, it was necessary to harmonize the laws on companies in the Federation of Bosnia and Herzegovina and Republika Srpska, and on the other there was a need to fulfill conditions for the conclusion of Agreement of the Stabilization and Association with European Union (signed in June 2008), which required the full harmonization of domestic company law regulations with European legislation (Simić M., Rajčević M., 2006: 21,154)

<sup>2</sup> Priorities in the implementation of regulatory reforms were determined by representatives of the international community, through the Peace Implementation Council (PIC), the Office of the High Representative (OHR), the European Commission, and the permanent missions of the World Bank and the IMF with more or less successful cooperation with the Council of Ministers of BiH, entity governments and the Brčko District of BiH. The first package of the laws in 1997 named "Quick Start Package" set the priorities for economic reforms and drove a series of laws at the state level (Law on the Central bank of BiH, Law on Foreign Trade Policy, Law on External Debt BiH, Customs Tariff Act, Foreign Direct Investment Policy Act) . The second package of laws prepared in cooperation with the European Commission named "Roadmap to BiH towards the European Union" included laws in the following fields:

- the regulatory framework for changing the structure of the political system,
- the regulatory framework of the Road Map for Economic System Reform and
- reform of the regulatory framework of the system in the field of democracy, human rights and the rule of law.

While the third phase marked the elaboration of the Feasibility Study for the accession of BiH to the European Union, the necessary reforms were defined in 16 priority areas, including customs and tax reforms (Penev S., Čaušević F., Filipović S, Madžovski M, Mancellari A., Marušić A., Shapo Z.; 2010; 164, 165).

the process of globalization<sup>3</sup>, relying on the use and development of modern communications and technologies, brought new challenges and imposed demands for inclusion in the global market and building national competitiveness. With the continuous need to build a competitive economy<sup>4</sup>, increasing domestic and attracting foreign investment, one achieves, to a greater or lesser extent, tax competitiveness with significant reforms and accompanying changes in tax legislation.

In addition, as a state located in the southeast of the European continent with the intent to acquire the conditions for full membership in the Union, Bosnia and Herzegovina is directed to economic and financial cooperation with the countries in the region and the EU Member States. A commitment to integration<sup>5</sup>, such as the European Union, implies both the alignment of tax legislation with the "acquis communautaire", and the future renunciation of a part of fiscal sovereignty and the inclusion in the process of harmonization of the tax system with the systems of EU member states.

## **1. LEGAL FRAMEWORK OF THE TAX REFORM IN BOSNIA AND HERZEGOVINA**

In the context of the process of economic reforms in BiH the Declaration of the Peace Implementation Council of 30 January 2003 emphasized the introduction of a uniform customs administration and VAT at the state level as an essential part of the reform process. High Representative for Bosnia and Herzegovina Paddy Ashdown<sup>6</sup> initiated

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<sup>3</sup> Gregory & Stuart under the environment imply factors that affect economic results excluding politics and the economic system itself, emphasizing that the world in which we live undoubtedly changed one factor of the environment - a revolution in the field of information, telecommunications and transport that made it smaller, interconnected and competitive. Globalization means an increasing connection between world economies through the expansion of trade in goods, services and capital what leads to the costs reduction for transportation and interchange of information; From the 50's, trade growth was faster than the growth of the world economy, while the flow of foreign direct investment between countries was even more impressive. (Gregory & Stuart, 2014: 99 - 101),

<sup>4</sup> Staring in 2000 in order to simplify the administration, a series of activities have been undertaken to implement reforms in areas such as registration of businesses, inspections, licensing, customs and tax administration, with the help of the donor community. (Penev S. et al.; 2010, 162)

<sup>5</sup> The Stabilisation and Association Process started in 1999, while negotiations started in 2005. Bosnia and Herzegovina signed the Stabilization and Association Agreement with the European Union in June 2008, and the Agreement entered into force in June 2015. The Questionnaire of the European Commission was delivered to the Council of Ministers of BIH in 2016 and the answers are expected to be given by the end of 2017.

<sup>6</sup> Odluka o uspostavi Komisije za indirektnu poresku politiku, br. 103/03, 12 of February 2003, OHR, Sarajevo; Službeni glasnik BiH, br. 4/03.

the reform of the system of indirect taxes, with the aim to remove all existing barriers to the economic development of BiH and to create a single economic space (equal tax treatment of production, exchange and consumption within the state), to encourage domestic and foreign investments, to direct BiH towards integration into the European Union<sup>7</sup> (EU) and membership in the World Trade Organization (WTO). At the same time, the aim of these reforms meant the establishment of the fiscal sovereignty of BiH (through which the state is going to collect its original tax revenues). The reform of the system of indirect taxation in BiH was completed three years later. The replacement of indirect taxation on institutional basis was made, indirect taxes were transferred to the jurisdiction of the state of Bosnia and Herzegovina, in the period from 2003-2005 the Indirect Taxation Authority<sup>8</sup> was established and in 2006 the implementation of the Law on Value Added Tax has been started. VAT<sup>9</sup> in Bosnia and Herzegovina introduced a flat<sup>10</sup> standard tax rate of 17% and zero rate for the exported goods<sup>11</sup>.

The Constitution of Bosnia and Herzegovina is superior to the constitutions of the entities, the laws of Bosnia and Herzegovina and the Entities, as well as all other legal

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<sup>7</sup> The requirement for the beginning of negotiations to the conclusion of the Stabilization and Association Agreement was the elaboration of a feasibility study (analysis and determination of the country's ability to engage in the SAA process). In March 2003, the activities of elaboration the Feasibility Study for BiH began and the Questionnaire with 346 questions was delivered to the Council of Ministers of BiH by the European Commission. Within the 16 priority areas, the reform of the customs and tax system also took place. The constitutional jurisdiction of the entities in the field of indirect taxation was transferred to the level of the state of Bosnia and Herzegovina through the reform.

<sup>8</sup> - The Indirect Taxation Authority was established by the Law on the Merger of Customs Administrations and the Establishment of the Indirect Taxation Authority, Official Gazette of BiH, no. 18/03.

- By the Law on Indirect Taxation System, Official Gazette of BiH, no. 44/03, 52/04, 34/07, 49/09 and 32/13 – the jurisdiction for indirect taxes was transferred to the state level.

- On 1 January 2005, the ITA began to act as an independent administrative organization with a Single Indirect Tax Collection Account – the Law on the Indirect Taxation Authority, Official Gazette of BiH, no. 89/05.

<sup>9</sup> Zakon o porezu na dodanu vrijednost, Službeni glasnik BiH, broj 09/05, 35/05, 100/08, 33/17.

<sup>10</sup> Before the reform took place, from 1999 to the end of 2005, the Federation of BiH and Republika Srpska had two tax rates of 10% and 20% on goods and 10% on services. Until 1999 the sale tax on goods and services had four different tax rates in the Federation of BiH (5, 10, 15 and 20). Later on they were replaced by those of 12% and 24%.

<sup>11</sup> Law on VAT is in accordance with the European VAT Directives (6<sup>th</sup> Directive, later replaced by Directive 2006/112/EC): regarding the number of tax rates, the rates of VAT in BiH are standard, flat rate and zero rate and there are no reduced rates (in the EU only Denmark has a VAT flat rate, (see: KPGM, 2014, 4)); regarding the level of standard tax rates, these must be over 15%, and it amounts to 17 in BiH percent (only Luxembourg applies as low standard rate of VAT, see: EC, 2018, 75). Bosnia and Herzegovina is the only country in the region that applied a VAT flat rate, and at the same time the level of the standard tax rate is the lowest one. Exemptions without the right to deduct for public interests supplies and for the financial services are given to the taxpayers.



regulations. According to the Article III Paragraph 4 of the Constitution of Bosnia and Herzegovina the Presidency BiH has the task of taking over the role of coordination between entities in matters within their competence (harmonization of regulations, single economic area etc.). The Entities and the District of Brčko BiH, according to the Constitution of BiH and their constitutions, have the competence in the area of direct taxes. In the middle of the first decade of this century, after several regulatory reforms were implemented and gave the results, it was a time to start a reform in the area of direct taxes in the Entities and Brčko District.

The reform of the income tax system in the Republika Srpska was carried out in cooperation with the US Treasury and in the Federation of BiH in cooperation with external experts with the technical assistance of USAID (the United States Agency for International Development). Before the reform in the area of direct taxes in the Entities and Brčko District a schedular income tax was in application. Inherent to schedular taxes is that different income categories have undergone different income treatment depending on the origin of income source, without taking into account personal circumstances of the taxpayer and the taxpayer's dependents. The basic lacks of schedular taxation were complex multi-rate tax and social insensitivity towards the taxpayer, as well as its individual circumstances and conditions of living and generating the income.

## **2. PERSONAL INCOME TAX IN THE REPUBLIKA SRPSKA**

Switch from the schedular/analytic income tax system to the comprehensive/synthetic income tax system was conducted in the Republika Srpska in 2006. The income tax rate has been changed several times since 2006. In 2006 the Law on Income Tax<sup>12</sup> introduced two rates of 10% and 15%, then in 2008 those rates were replaced with the single one at 8% by Amendments to the Law, and by the next Amendments in 2011 the tax rate rose to 10% and remained at the same percentage to date.

Personal deductions on personal income tax were subject to change several times. In 2006 personal deduction amounted to 2.460 KM (205 KM per month) and dependents

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<sup>12</sup> Zakon o porezu na dohodak Republike Srpske, Službeni glasnik RS, br. 91/06, 128/6, 120/08, 71/10, 1/11, 107/13. Income tax shall be paid for income arising from: personal wages, income from independent business activity, copyrights, rights related to copyrights, and rights of industrial property, capital, and capital gain from movable property, and share in property of legal entities, foreign sources, and the other incomes. Tax rate is 10%.

deduction was established as 20% of the basic one (84 KM). The amount of basic deduction in 2008 was raised to 3600 KM, but it significantly decreased in the last nine years. At first it was reduced to 3000 KM in 2010, and again in 2013 to 2400 KM (200 KM per month). Also, the deduction for dependents decreased from 1080 KM to 900 KM in 2011.

### **3. OVERVIEW OF PERSONAL INCOME TAX AND CORPORATE INCOME TAX IN THE FEDERATION OF BOSNIA AND HERZEGOVINA**

In 2008 comprehensive personal income tax was introduced in the Federation of BiH<sup>13</sup>.

When it comes to direct taxes in Bosnia and Herzegovina, one should certainly mention and particularly emphasize the need to harmonize legislation between the Entities and the District in order to equalize the tax payers' treatment, and it is necessary to continually work on the mutual monitoring, coordination and harmonization of regulations regarding the elements of income taxation, in particular the rates and the basis of income tax.

In the Federation of BiH, the reform of income tax was being carried out in parallel with the corporate tax reform, with the aim of establishing an equal tax treatment of income from various sources in the territory of the Federation of BiH and harmonization within the Federation, as well as with the legislation in the RS. The harmonization of regulations within the FBiH was introduced for the purpose of enabling the creation and functioning of a single economic space in BiH, and providing equal tax treatment and equal conditions of business for taxpayers in the Federation of BiH in the spirit of freedom of movement and housing and right to work. Through the reform, corporate income tax rates had been reduced from 30% to 10% and the exemptions had been abolished; income tax introduced at a rate of 10% - flat tax<sup>14</sup>. The Federation of Bosnia and Herzegovina modernized its tax structure and removed

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<sup>13</sup> Zakon o porezu na dohodak, Službene novine Federacije BiH, br. 10/08, 44/11, 7/13 i 65/13.

<sup>14</sup> Prior to the reform, the cantons in the Federation of BiH had competences to regulate personal income tax, which concerned the following sources: tax on the profit of individual persons (25% rate), property tax (paid in lump sum), property income and property rights (the rate could not be less than 20% of tax base), tax on copyright, patents and technical improvements (rates were 10, 15 and 20%, and in the case of inheritance and transfer of copyrights, tax rate increased for an additional 20%), inheritance tax and gifts (6% for real estate and 10% for movable property), gambling tax (20%), income tax from agricultural activity (tax rates were determined by municipal councils), the tax on total income of individuals (15%), (see: Sudžuka, 2014, 279).

varieties of taxes and disparities in tax treatment, and by avoiding double taxation of the same income, it reduced tax pressure on certain categories of income, and took over activities on harmonization of tax systems to the other entity and district; personal, marital, children, family and disability deductions were recognized; tax cards have been introduced as the basis for recognition of tax benefits, income payment is possible only on employee bank accounts (no cash payment), the taxpayer is not an employer any more but an employee, and filing of the tax form/declaration has been introduced. Choice for a proportional tax rate in relation to progressive rates was made because of its advantages based on the simplicity of a proportional, i.e. flat tax model to application: this facilitates taxpayer activities and the work of tax officials employed in tax administrations, taking into consideration time and costs this type of rates contributes to faster accomplishment of tax payers' obligations and faster and easier control by the tax administration. Application costs are going to be lessened.

Bearing in mind that countries in transition often have shortcomings in terms of tax administration, the financial theory recommends building a simpler tax system, broadening tax base with more uniform tax rate structures as a way to make tax policy measures compatible with existing administrative capacity<sup>15</sup>. Ganghof claims: Since income taxes are comparatively difficult to administer, developing countries can opt for a proportional tax rather than a dual model, especially if they have a low level of administrative capacity. In this case, income tax can not achieve the function of settling progressivity within the tax system. In this respect, it will be important to explore ways of distributing tax burden on other taxes and contributions, in a way that involves a wider spreading of tax base, greater equity, and effectiveness (2005, 89). Even the recent trends in tax reform regarding comprehensive income tax point out that some countries aimed at lowering labour and corporate income, taxes shift towards an increased consumption or environmentally related taxes. In the post crisis period of several years, income taxes steady increased, then in 2015 became stable, and the trend in 2016 moved forward reducing the burden on labour income through decreases of tax rates and expansion of allowances and credits especially for low-income taxpayers and households with children (Estonia and Spain in 2015). In some countries rate reductions have been followed by base broadening (and only in Sweden it led to a rise of tax burden on labour income), while tax rates on capital incomes, such as dividends increased (OECD, 2016, 31).

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<sup>15</sup> The reform of tax administration at state level, as well as at the level of entities and the district, preceded the reform of substantive and procedural tax law.

Tax rate on personal income levied at 10% in both entities and the district. The same tax rate has been established on corporate income.<sup>16</sup> By the Law on Corporate Income Tax in the Federation of BiH in 2008 the tax rate were shifted from 30% to 10%, corporate income tax reliefs (applied to new companies for the first years of business 100%, 70%, 30%) were rated as a cause of harmful tax competition and derogated so a significantly lower levels of effective taxation was imposed. A new Law on Corporate Income Tax of 2016 predicts a relief of 30% tax amount for the investments over 50% of profit. If an investment exceeds the amount of 20 million KM (at least 4 million in the first year) during five years, the tax amount will be decreased for 50%. Deductible expense will be recognized as a double amount of gross income for a newly employed person.

Personal income rates in BiH are one of the lowest tax rates among countries in the region (Dimitrijević: 2013, 245), and their impact on the tax system is considered to be positive. Moreover, the tax system became more competitive in comparison with the systems of the countries in the region, and it created good conditions for the investment and the employment; the relatively lower level of tax burden on labour and self-employment should have a positive impact on the development of small private entrepreneurship and crafts, initiation for a new job positions opening, and the rise of employment (especially in the Federation of BiH, self-employment income tax before the reform was 25%, while the Republika Srpska had progressive income tax rates of 10 and 15 percents).

#### **4. COMPETITIVENESS AND TAX COMPETITIVENESS**

Competitiveness could be understood in a few different ways: as the ability of companies to compete in domestic and world markets; as a better standard of living; then as a set of institutions, policies and factors that determine the level of productivity of a country; it is a determinant for economic growth and job creation. Porter (2006) claims: With respect to labour, it is not so much the quantity of labour that affects your competitiveness in a given field, but rather it is specialisation and the quality of labour that are important. So it is crucial to recognise that the advantages arise less from

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<sup>16</sup> Zakon o porezu na dobit, Službene novine Federacije BiH, broj 15/16. Zakon o porezu na dobit, Službeni glasnik RS, br. 91/06 i 57/12. Zakon o porezu na dobit Brčko Distrikta BiH, Službeni glasnik Distrikta Brčko BiH, br. 60/10.

inputs in the conventional sense, and more from technology and the efficiency with which those inputs are utilised (Snowdon B. & Stonehouse G., 2006, pg.167).

Competitiveness has its internal and external elements. In this paper only external ones such as the government regulations and support to the development of business will be mentioned. The state could approve different incentives for building competitiveness. Fiscal indirect incentives are actually tax incentives seen as investment allowances, tax deductions, reduced tax rates. Fiscal direct incentives appear as the mode of co-financing: employment, research and development etc. Financial incentives such as staff training, re-qualification, infrastructures, and non-financial incentives i.e. rule based - ease of doing business: permitting procedures and licensing, ownership rights, contracts enforcement, resolving the insolvency issue. Incentives for investments in human capital are for instance employment incentives: a) tax incentives for the existing employment; b) tax incentives for the new employment, and c) tax incentives for small and medium business that stimulate employment and investment.

The ways to incentives through taxation are: the narrowing of tax base and lowering of tax rate. The shrinking of tax base could be done by two modes, through tax exemptions i.e. the establishment of tax threshold until earned income is not taxable anymore, and through tax deductions for taxpayer and eventually their dependents and depreciation. The lowering of tax rate could be made in two ways, the first one is to reduce/decrease nominal tax rate, and the second one is to issue a fixed amount of tax levy to certain categories of taxpayers. In the latter case, various ways are used for shrinking taxes levied on employment and income decreasing tax load and lessening labour costs as one of the main factors of economic activities of the business sector.

In the Republika Srpska<sup>17</sup> the income tax base is reduced by the following measures:

- a) annual personal deduction for the taxpayer, in the amount of KM 2,400, 200 KM (cca. EUR 100) at monthly level,
- b) KM 900, at annual level, for each dependent member of close family whose income and other revenues do not exceed the amount of KM 3,000 (deduct KM 75 i.e. 38 monthly),
- c) amount of interest paid to housing loans for the first acquiring ownership of immovable property, and

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<sup>17</sup> Zakon o porezu na dohodak Republike Srpske, Službeni glasnik RS, br. 60/15 i 5/16.

- d) amount of paid pension contribution for voluntary pension insurance, up to 1,200 KM per year,
- e) payment of life insurance up to KM 1,200 per year.

In the order to obtain tax incentive, small entrepreneurs have to fulfill each of the following conditions during the full tax year: a. individual performs independent activity, except liberal professions (lawyers, notaries, financial services and organizing of games of chance), b. the number of employees of a small entrepreneur does not exceed three persons, c. the total annual revenue of small entrepreneur does not exceed the amount of KM 50,000. Tax rate for small entrepreneur is 2% of their total realized income, but tax could not be less than 600 KM. The tax on incomes from foreign sources are paid annually in absolute /fixed amount: for investors who invests up to 2 million KM, the annual tax amounts to KM 150,000; on investments from 2 to 10 million KM, the annual tax is KM 250,000; on investments from 10 to 20 million KM, the annual income tax is KM 500,000; on investments from 20 to 30 million KM, the annual tax amounts to KM 600,000; on investments from 40 to 50 million KM, the annual tax amounts to KM 700,000, and if over 50 million KM is invested, the annual tax amounts to KM 800,000.

Social security taxes i.e. contribution in RS<sup>18</sup> are applied at the following rates:

- a) for pension and disability insurance 18.5%,
- b) for mandatory health insurance 12%,
- c) for unemployment insurance 1% and
- d) for child's protection 1.5 %.

Total SST rates are 33%. All taxes are the responsibility of employee who bears the burden of taxation.

Here is an example of the personal wage tax burden in the Republika Srpska: it is based on the estimated gross income of KM 2450. An employee who is the breadwinner for his family (wife, two children) earns grossly KM 2450, which approximately equals to 1250 €,

KM 2450 - 33% (SST 808.5 KM) = KM 1641,5

Gross income is KM 1641.5 - KM 425 (deductions 200+75+75+75) = KM 1216.5

Tax base of income tax is amount of KM 1216.5 x 10% tax rate

Total income tax 121.65 (PIT)

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<sup>18</sup> Zakon o doprinosima, Službeni glasnik RS, br. 116/12 i 103/15.

Net (after tax income)  $1216.5 - 121.65 = \text{KM } 1094.85$

Total after income tax  $1094,85 + 425$  (deductions) = KM 1519.85 closely 775€

Total taxes  $808.5 + 121.65 = \text{KM } 930.15$  closely 475 €

Tax burden on gross earnings is 37,96%.

Employee bears the tax burden imposed by all above mentioned taxes.

Table 1

1	Gross Earned Income	KM 2450.00
2	Social Security Contributions (1x33%) GEI x33%	KM 808.50
3	Net Income after SSC Gross income before PIT (1-2)	KM 1641.50
4	Personal Deductions (Total amount)	KM 425
	Taxpayer Basic Personal Deduction	KM 200
	Dependent - spouse (fixed amount )	KM 75
	Dependent - 1 child (fixed amount )	KM 75
	Dependent - 2 child (fixed amount)	KM 75
5	Income Tax Base (3-4)	KM 1216.50
6	Personal Income Tax Rate 10% PIT Amount (5x10%)	KM 121.65
7	Net Income (after tax) 5-6)	KM 1094.85
8	Net Income For Payment (3-6 or 4+7)	KM 1519.85
9	Total Taxes SSC +PIT (2+7)	KM 930.15
10	Total Tax Burden (9/1x100) TT:GEIx100	37.96%
11	Social Security Contributions share in Total Taxes (29x100) SSC:TTx100	86.92%
12	PIT share in Total Taxes (69x100) PIT:TTx100	13.08%
13	PIT Burden as percent of Gross Income (6/1x100) PIT A:GEI x 100	4.96%

14	PIT Burden as percent of Net Income (68x100) PIT A:NIFP x 100	8.00%
15	Ratio of SSC and PIT in Total Taxes (1 : 100/12-1)	1: 6.65

Table 1 shows that the amount of income tax which the taxpayer must pay in the amount of KM 121.65 represents 4.96% of the employee's earned gross income, i.e. income tax burdens the 8% of net earned and paid income. Social security contributions amount to 86.92 %, while income tax, in total tax burden, amounts to 13.08%. The ratio of burdening with personal income tax in comparison to burdening with social insurance contributions is 1:6.65. Total tax burden in Republika Srpska is 37.89%.

In the Federation of BiH the income<sup>19</sup> tax base is reduced in the following way:

- a) basic annual personal deduction of income applied for a taxpayer is KM 3,600, i.e. KM 300, which approximately equals to EUR 150 at monthly level,
- b) personal deduction KM 1800 at annual level for a spouse and for the first child (KM 150 monthly); for the second child the deduction is KM 2520 ( KM 210); for the third and the next child the amount is 3240 (270 KM); other dependent member of close family - parents KM 1080 ( KM 300 multiplied by 0.3 (coefficient) gives the monthly amount of KM 90 ), as well as for disability of taxpayer or member of their family if dependents income and other revenues do not exceed the amount of KM 3.600.
- c) amount of interest charges paid to housing loans for the first acquiring ownership of immovable property, and
- d) amount of cost that taxpayer bears related to the health service and medicines procurement, procurement of orthopedic devices and prosthetic substitutes, if they are not covered from the basic or supplementary health insurance nor funded by donations.

Social security taxes/contributions in the Federation of Bosnia and Herzegovina<sup>20</sup>are:

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<sup>19</sup> Taxable income includes: a) employment income - salary, b) independent business activity i.e. self-employed (crafts and entrepreneurship, agriculture and forestry, liberal professions, other independent personal activities), c) property (renting and alienation) and property rights (copyrights, industrial rights), d) capital investments (interest on loans, voluntary supplemental insurance), and e) winning prizes and gambling winnings.

<sup>20</sup> Zakon o doprinosima, Službene novine Federacije BiH, br. 35/98, 54/00, 16/01, 37/01, 1/02, 17/06, 14/08, 91/15, 104/16.



- a) The mandatory pension and disability insurance tax rates sum is 23% .  
 - 17% employee contributions and  
 - 6% employer contributions,
- b) The mandatory health insurance tax rate sum is 16%  
 - 12,5% employee contributions and  
 - 4% employer contributions,
- c) Unemployment insurance 2%  
 - 1.5% employee contributions and  
 - 0.5% employer contributions,

Total social security contributions rate in the Federation of BiH is 41.5%.

An example of the personal salary tax burden in the Federation of BiH:

it is assumed that an employee who is the breadwinner in his family (with wife and two children) earns the gross income of KM 2450, which approximately equals to € 1250.

Gross earned income KM 2450

- 41,5% Soc. Sec. Tax (KM 1016.75 closely to €) 519.25 = KM 1433.25 (€)730.75

Income tax base is KM 1433.25 - KM 810 ( KM 300 + 150 + 150 + 210 personal and deductions for dependent) = KM 623,25

Income tax base is 623.25 KM x 10% tax rate

Income tax amount is KM 62,325 (PIT)

Net income (after tax) KM 623.25 - KM 62.325 = 560.925

Total income KM 560,925 + KM 810 = 1370,925 approximately EUR 700

Total taxes 1016,75 K (SST) + 62.325 (PIT) = KM 1079.075 EUR 519.25 + EUR 30.75 = closely EUR 550

Tax burden is 44.04%.

Table 2

1	Gross Earned Income	KM 2450.00
2	Social Security Contributions (1x41,5%) GEI x41,5%	KM 1016.75
3	Net Income after SSC Gross income before PIT (1-2)	.1433,25
4	Personal Deductions (Total amount)	KM 810

	Taxpayer Basic Personal Deduction	KM 300
	Dependent - spouse (A x 0,5 )	KM 150
	Dependent - 1 child (A x 0,5 )	KM 150
	Dependent - 2 child (A x 0,7 )	KM 210
5	Income Tax Base (3-4)	KM 623.25
6	Personal Income Tax Rate 10% PIT Amount (5x10%)	KM 62.325
7	Net Income (after tax) (5-6)	KM 560.925
8	Net Income For Payment (3-6 or 4+7)	KM 1370.925
9	Total Taxes SSC +PIT (2+7)	KM 1079.075
10	Total Tax Burden (9/1x100) TT:GEIx100	44.04%
11	Social Security Contributions share in Total Taxes (2/9x100) SSC:TTx100	94.22%
12	PIT share in Total Taxes (6/9x100) PIT:TTx100	5.78%
13	PIT Burden as percent of Gross Income (6/1x100) PIT A:GEI x 100	2.54%
14	PIT Burden as percent of Net Income (6/8x100) PIT A:NIFP x 100	4.55%
15	Ratio of SSC and PIT in Total Taxes (1 : 100/12-1)	1: 16.3

The Personal Income Tax (PIT) rate, the amount of payable tax and Social Security Contributions (SSC) and the share of each in total tax burden, as well as the ratio of PIT and SSC for the Federation Bosnia and Herzegovina, as shown in the table above, will be explained in the text below.

We could take into account an employee who is the breadwinner of his family i.e. spouse and two children. We assume that the taxpayer, who is at the same time obliged to pay social contributions, earns before taxing their KM 2450 income which is approximately equal to €1250. On their gross earned monthly income the following social contributions are calculated first: the mandatory pension and disability insurance – the rate of 6% (employer's contributions), the mandatory health insurance

– the rate of 4% and unemployment insurance – the rate of 0.5%, which means that the total burden of social security contributions for the employer is 10.5%.

The following social contributions are calculated next:

the mandatory pension and disability insurance at the rate of 17 % (employee's contributions), the mandatory health insurance at the rate 12.5% (employee's contributions) and unemployment insurance rate of 1.5% (employee's contributions), which means that the total burden of social security contributions for the employee is 31%. Total social security contribution rate is 41.5%.

After the application of contributions set at the previously stated rates, we will get gross income to which income tax should be applied. Personal income tax provides basic personal deduction for the taxpayer in the amount of KM 300, and dependents deductions, which are determined by the application of scheduled coefficients ( $0.5 \times 300 = \text{KM } 150$ ;  $0.5 \times 300 = 150 \text{ KM}$ ;  $0.7 \times 300 = \text{KM } 210$ ) to the amount of basic personal deduction. The tax base for the application of tax rate PIT will be obtained (KM 623.25) after subtraction of the total amount of tax deductions (KM 810) from gross income before taxation (KM 1433.25).

Table 2 shows that the amount of income tax which the taxpayer must pay in the amount of KM 62.325 represents only 2.54% of employee's earned gross income, i.e. income tax burdens only 4.55% of net earned and paid income. Social security contributions amount to 94.22 %, while income tax, in total tax burden, amounts to 5.78%. The ratio of burdening with personal income tax, in comparison to burdening with social insurance contributions, is 1:16.3. Total tax burden in the Federation of Bosnia and Herzegovina is 44.04% while, at the same time, the burden in the Republika Srpska is 37.89%. Income tax and social security contributions create a more competitive system of direct taxes of the Republika Srpska than the system of the Federation of Bosnia and Herzegovina in the field of personal wages taxation and calculating labour costs.

As previously stated, it is possible to conclude that the burdening of labour with social contributions is much higher than burdening with personal income tax. Having in mind that the burdening of income of an employee who supports family of four members is established by the effective rate of 4.55 percent of net earned income, i. e. 2.54% of gross earned income, is much lower than legal tax rate of 10%, it is possible to conclude that income tax represents a relatively low burden on employee earnings,

because of indirect progression accomplished with the application of personal and dependents deductions. On the other hand, there are social contributions which represent a very high tax burden on earned incomes, both for employers and employees. Contributions make tax system in the part of direct taxes which burden the labour, i. e. the incomes of dependent labour (personal wages) and incomes in the self-employment sphere, less competitive, or uncompetitive to tax systems of countries in the region. While tax rate on personal income is lower, social security contributions rates in the Federation of Bosnia and Herzegovina are above average in other entities and Brčko District in BiH or other countries in the region<sup>21</sup>.

In Brčko District the personal income tax rate is 10% and personal deductions are the same as those applied in the Federation of BiH. The total social security contributions tax rate in Brčko District is 31.5% or 36.5%.<sup>22</sup>

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<sup>21</sup> In Croatia, Personal Income Tax is applied at progressive rates of 12.25 and 40%, social security contributions from the salary borne by the employer are applied in the amount of 17.2%, and employee contributions in the amount of 20%. In addition, the surtax on personal income tax rate amounts vary between municipalities (10%) and cities (12, 15 and 18 % in the city of Zagreb). Šimović & Deskar-Škrbić (2015) are acknowledging that: "the greatest influence on the tax wedge structure in Croatia has social contributions, for all levels of observed gross income, the employer's contributions account for 14.7%, while employee contributions account for 17.1% of total labor costs. Income tax and surtax on income tax progressively rise, and at the level of average salary together they reached the amount of 8%. In the other words, social security contributions burdens the average labor cost in Croatia four times more in relation to income tax and surtax" (pg.8). In Serbia, social security contribution rate for pension and disability insurance is 26% (14+12%), health insurance is 5.15% for the employer and the same amount is borne by the employee, unemployment insurance is 0.75% for the employer as well as the employee, and the total SSC rate is 36.8 % (see: <https://www.pio.rs/lat/osnovice.html>). Personal income tax rate is 10% and personal allowances enables indirect progression. Until December 2017, the Law on Social Security Contributions foresaw the application of the employment incentives as follows: from 1-9 newly employed person 65% of SSC return, from 10-99 newly employed persons a return of 70% SSC, and for above 100 newly employed persons a return of 75% of paid SSC.

<sup>22</sup> Social security taxes/contributions in Brčko District encompasses the following taxes: the mandatory pension and disability insurance tax rate is 17% or 23%. SST rate is 17% as employee contributions (if the Law on Contribution of Federation of BiH is applied), or 18% (if the Law on Contribution of Republika Srpska is applied). Additional rate applied at 6% as employer contributions (if the Law on Contribution of the Federation of BiH is applied). The mandatory health insurance tax rate is 12%, it is an employee contribution. Unemployment insurance bears employee and its tax rate is 1.5%.

## 5. TAX REFORM ON AGENDA IN THE FEDERATION BIH

According to the Draft on Law of Personal Income Tax<sup>23</sup>:

Personal income tax rate will be shifted to the progressive tax rates at 10% for earned incomes up to KM 1500 and at 20 % for incomes over KM 1500 (Art. 12).

Derogation of marital and children deductions and increase of personal deduction amount to KM 700 (Art. 45).

The broadening of tax base to capital gains (profit shares, dividends, interests on deposit savings, securities).

The introduction of lump sum taxation for self-employers (at the amount of KM 50.70 or 80)

An example of tax burden on personal income/salary according to the 2018 proposal:

an employee as the breadwinner in his family (wife and two children) earns gross income KM 2450, which approximately equals to EUR 1250.

Gross earned income KM 2450

- 41.5% Social Security Tax (SST is KM 1016.75, which approximately equals to EUR 519.25) = KM 1433.25 (EUR 730.75)

Income tax base KM 1433.25 - KM 700 (personal deductions) = KM 733.25

Income tax base is KM 733.25 x 10% tax rate

Income tax is KM 73.325 (PIT)

Net income is KM 659.925+ 700 = KM 1359.925 closely to EUR 695 (EUR 337.5 + 357.5)

Total taxes 1016.75 (SST) + 73.325(PIT) = KM 1090.075 approximately equals EUR 555 (EUR 519.25 + EUR 35.75)

Tax burden is 44,49%

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<sup>23</sup> Nacrt Zakona o porezu na dohodak Federacije BiH - Federalno Ministarstvo finansija, Sarajevo: March 2017 - available at [http://www.fmf.gov.ba/v2/aktuelno.php?akt\\_id=3103](http://www.fmf.gov.ba/v2/aktuelno.php?akt_id=3103)

Table 3

1	Gross Earned Income	KM 2450.00
2	Social Security Contributions (1x41,5%) GEI x41,5%	KM 1016.75
3	Net Income after SSC Gross income before PIT (1-2)	KM 1433.25
4	Personal Deductions (fixed amount)	KM 700
5	Income Tax Base (3-4)	KM 733.25
6	Personal Income Tax Rate 10% PIT Amount (5x10%)	KM 73.325
7	Net Income (after tax) (5-6)	KM 659.925
8	Net Income for Payment (3-6 or 4+7)	KM 1359.925
9	Total Taxes SSC +PIT (2+7)	KM 1090.075
10	Total Tax Burden (9/1x100) TT:GEIx100	44.49%
11	Social Security Contributions share in Total Taxes (2/9x100) SSC:TTx100	93.27%
12	PIT share in Total Taxes (6/9x100) PIT:TTx100	6.73%
13	PIT Burden as percent of Gross Income (6/1x100) PIT A:GEI x 100	2.99%
14	PIT Burden as percent of Net Income (6/8x100) PIT A:NIFP x 100	3.74%
15	Ratio of SSC and PIT in Total Taxes (1 : 100/12-1)	1: 13.8

Considering the reform of social security contributions proposed by the Federal Ministry of Finance, the tax rates of contributions would be slightly increased at the expense of employee (Art. 12), while contributions at the expense of employers would be abolished. The tax burden of SSC on earned income could be presented in the following way:

Table 4

1	Gross Earned Income	KM 2450.00
2	Social Security Contributions (1x33%) GEI x33%	KM 808.50
	Mandatory pension and disability insurance 18.5%	KM 453.25
	Mandatory health insurance 13.5%	KM 330.75
	Unemployment insurance 1%	KM 24.50
3	Net Income after SSC Gross income before PIT (1-2)	KM 1641.5
4	Personal Deductions (fixed amount)	700 KM
5	Income Tax Base (3-4)	KM 941.5
		KM 800
		KM 141.5
6	PIT Total Amount Personal Income Tax Rate 10% (5x10%) Personal Income Tax Rate 20% (5x10%)	KM 108.30
		KM 80
		KM 28.3
7	Net Income (after tax) (5-6)	KM 833.2
8	Net Income for Payment (3-6 or 4+7)	KM 1533.2
9	Total Taxes SSC +PIT (2+7)	KM 916.8
10	Total Tax Burden (9/1x100) TT:GEIx100	37.4%
11	Social Security Contributions share in Total Taxes (2/9x100) SSC:TTx100	88.18%
12	PIT share in Total Taxes (6/9x100) PIT:TTx100	11.81%
13	PIT Burden as percent of Gross Income (6/1x100) PIT A:GEI x 100	4.42%
14	PIT Burden as percent of Net Income (6/8x100) PIT A:NIFP x 100	7.06%
15	Ratio of SSC and PIT in Total Taxes (1 : 100/12-1)	1: 7.46

Latter reviewed examples confirm that the income tax reform on agenda is going towards fiscal neutrality, and a slight change in the tax load of 0.41%, with evident shifting in the ratio of SSC and PIT in total taxes from 1:16.3 to 1:13.8, shows that tax burden after the reform should move downward because the decrease of PIT burden from 4.55 (Table 2.) to 3.74% (Table 3) i.e. 4.42% (Table 4) of net income (after the reform, tax load in the Federation of BiH would be less than in the Republika Srpska where it is 4.96% - Table 1). Total tax burden on income after social security contributions would be decreased to 37.4%, which is close to the existing burden of 37.89% in the Republika Srpska. Considering the tax burden of personal wages, i.e. of labour, it is noticeable that the tax burden in the Republika Srpska is lower than the burden in the Federation of BiH, mostly because the reform of social security contributions and abolition of the rates that the employers used to bear. In order to achieve harmonization of social security contributions and higher tax competitiveness in the Federation of BiH<sup>24</sup>, it is necessary, in parallel to the reform of personal income tax, a reform of the social security contribution has been conducted and tax rates have been reduced.

The above reforms are aimed at expanding personal income tax base, through reducing the number of exemptions for dependents and subsuming the fringe benefits in the tax base, whilst the amount of personal deduction is to be increased. Other income sources, such as dividends, will become taxable. All of the planned reform

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<sup>24</sup> Government's reform agenda 2015-2018 foresees decreasing fiscal burden on labor. Introducing progressive tax rate of personal income tax. Plan of action: New Law on social security contributions aimed at widening tax base and decreasing tax rates. Corporate income tax should introduce investment allowance. See: Reformska agenda za BiH za period 2015-2018. godina dostupno na: <http://www.fbihvlada.gov.ba/pdf/Reformska%20agenda.pdf>  
Akcionni plan Federacije Bosne i Hercegovine za realizaciju reformske agende za BiH za period 2015. – 2018. godina dostupno na: [http://www.fbihvlada.gov.ba/pdf/Akcionni\\_plan.pdf](http://www.fbihvlada.gov.ba/pdf/Akcionni_plan.pdf)



steps should result in the simplification<sup>25</sup> of the tax system and achieving vertical fairness<sup>26</sup>.

## 6. CONCLUSION

When comparing tax competitiveness with national competitiveness, it is clear that tax competitiveness will be just a drop in the bucket of competitiveness if macroeconomic stability, application of new technologies, environmental and political factors do not contribute to increasing the investments, productivity and economic development of the country. A combination of financial i.e. rule-based incentives with fiscal incentives in parallel with coordination of different macroeconomic policies should be focused on achievement of two aims: to induce economic progress and to develop competitiveness.

With respect to the value added tax levied at a flat rate, in order to neutralize the tax system's regression, social taxation targets were accomplished outside the indirect tax system. The introduction of comprehensive personal income tax e.g. flat tax in entities and the district in Bosnia and Herzegovina decreased the number and level of tax rates. Although flat tax rate is applied in the Federation of Bosnia and Herzegovina, personal income tax includes personal exemptions and exemptions for dependents all of which make this tax progressive. Indirect progressiveness leads to a more equitable distribution of the tax burden according to the taxpayer's ability through the protection of its existential minimum. The progressive effect of personal income tax lessens

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<sup>25</sup> Simplification will be met in the area of:

- social security contributions regarding the derogation of tax rates borne by the employer (three rates instead of six),
- the same amount of social security contributions in both entities and the district;
- personal income tax base - broadening the base and the derogation of fringe benefits as non-taxable income,
- personal income tax base - establishing only one type of personal allowance - basic personal deduction for the taxpayer and derogation of dependents deductions.

While at the same time, more complex elements of personal income tax appears. Tax rates will be introduced as a progressive (10 and 20%) because of increases in the basic personal deduction amount, so the income tax reform should have a fiscal neutral outcome. Introducing more than one tax rate in taxation of incomes will rise costs of its implementation for the taxpayer and tax administration, and higher costs mean increased labour expenses for employers and lessened fiscal revenues for the state.

<sup>26</sup> Vertical fairness is going to be reached to certain extent because all incomes amounts over 1,500 KM are subject to taxation by the higher tax rate of 20% instead of the current 10%. But it is questionable whether fairness will be achieved when comparing taxpayers of the middle income groups with taxpayers of the high income groups.

regression of the entire tax system and reduces the tax burden on labour, especially for taxpayers with lower income and more dependents.

Apart from the planned reform of personal income tax, tax competitiveness related to the personal income tax could not be considered without the social security tax reform. Though the reform of PIT decreases the anticipated tax burden and lowers costs of labour, reductions of social security taxes rates are necessary to achieve greater efficiency and competitiveness.

Considering that social security contributions and income taxes, as a compulsory expenditure, increase the load on employers, the reductions of social security tax rates (abolishing SST for employers) and increase of amounts of personal income tax exemptions would mean lowering labour costs and releasing a part of the funds for new investments and for new jobs thus widening the scope of economic activity. At the same time, it is expected to encourage taxpayers in their intention to pay taxes, i.e. it raises tax compliance and will diminish the scope of shadow economy. That would gradually, observed in the long run, lead to an increase in fiscal revenues.

The Federation of Bosnia and Herzegovina is less tax competitive than the Republika Srpska. The tax burden of labour is higher because of social security taxes, which makes labour costs higher. Direct government support for the first-time employment (up to the one year for the first work experience) contributes to reducing the unemployment rates. When taking into account slow improvement in solving the issue of unemployment, one raises a question: is direct financial support a convenient long-term solution in the view of the ratio between the employee and retired (1.28 : 1), limited future manpower and brain drain, negative relation between birth rate and mortality rate? - which remains open. The state should conduct several strategies in the area of employment, demographic and social policy to solve this and similar issues, to keep the workforce of particularly young educated person and to establish sustainable tax system, as well as the pensions funds.

There is still room for wider use of tax policy's instruments (employment incentives) in order to achieve economic goals such as the development of business sector, small and medium enterprises and increase competitiveness. Tax expenditures for business may increase productivity and economic growth.

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## **THE FLEXIBILITY OF EMPLOYMENT AS A BASIS FOR THE EMPLOYERS' COMPETITIVENESS IN BOSNIA AND HERZEGOVINA**

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### **SUMMARY**

*Since the early 21<sup>st</sup> century, the modern labour legislation is addressing the challenges of the conditions in the labour market. The concept of flexibility/flexicurity in the labour market is widely used as an answer to overcoming the economic crisis. The flexibility of the employment may be assessed from the employer's and the employee's perspective. If assessed from the employer's perspective, in principle, it will largely overlap with the assessment of competent public authorities. This is because both employer and public authorities find the enhanced flexibility as a necessary requirement for better competitiveness in the market. In the employer's perspective, the flexibility increases the competitiveness in the internal market i.e. micro plan, and in the public authorities' perspective, it enhances the competitiveness of economy as a whole i.e. macro plan, necessary for attracting direct or indirect foreign investments. In the employees' perspective, the flexibility of the employment is important regarding the easy establishment of the employment status, but also to achieve a balance between their education, family and other obligations in certain periods of life.*

*Typical forms of external or contractual flexibility are represented in the possibility of establishing a fixed-term employment, part-time employment, homework employment, employment with probation period and employment with a trainee. Within this type of flexibility, the dismissal protection legislation is being assessed with particular regard.*

*Internal flexibility is reflected in the possibility of scheduling working hours and tasks according to the needs of the employer as well as the employees.*

*The paper will analyse the employment flexibility in the labour legislation in Bosnia and Herzegovina, namely the Federation BiH, the Republika Srpska and Brčko District BiH.*

**Keywords:** *flexibility, fixed-term contract, part-time employment contract, homework employment, termination of employment.*

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## INTRODUCTION

The term flexibilisation derives from the term flexibility (*lat. Flexibilitas*), meaning pliancy, slimness, and variability (Domović, Anić, & Klaić, 2001). In the context of the employment, flexibilisation could be understood as variability (and figuratively pliancy) of what is usually perceived as a standard employment. Hence, two basic determinants of standard employment are that it is a full-time employment for an indefinite period. This type of employment was fully affirmed in the era of Fordism that lasted from the end of the Second World War until the mid-1980s.<sup>1</sup> In general, the full-time employment for indefinite period is the main source of livelihood of employees, and that is why it is in focus of state's labour protection legislation.

The content of the labour law is comprised of individual and collective labour rights and rights related to labour.<sup>2</sup> Fundamental individual labour rights and rights related to labour include: 1) right to legal employment, 2) right to salary, 3) right to fixed working hours, 4) right to vacation, 5) right to safety at work, and 6) right to employment security. These rights were, foremost, established and developed to ensure employee's protection. In the aforementioned era of Fordism, they were an integral part of the wide social consensus of unions as representatives of employees, employers and competent public authorities. Therein they tried to avoid commodification of labour, and the employers were well aware of the need for social security of employees. According to Streek (2008), this consensus started collapsing in the 1970s, and it was gradually abandoned in the era of Ronald Reagan in the USA and Margaret Thatcher in Great Britain, with whom the era of liberalism begins. In addition, large companies are beginning to intensify their business in the international market (p. 9).

As the result of the globalisation process, characterised by technical and technological progress, much better communication and traffic connectivity, the economic systems of countries with the current legislation in place began to suffer a strong pressure

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<sup>1</sup> Fordism created the «standard» employee. He was a typical man, with a full-time job and usually with no skills, his working conditions were usually covered with the collective agreement and he was usually a member of the union who occasionally participates in strikes. Standard employee was employed for an indefinite period and worked on positions that were heavily controlled by the employer (Vettori, 2007, p. 9).

<sup>2</sup> According to some authors, what should certainly be understood as an extensive interpretation, the content of labour law, in the sphere of rights related to labour and employment should be interpreted in the broadest sense, especially in its relation to employment but it also includes the protection of the unemployed (Brajčić, 2001, p. 12).

under the need to maintain competitiveness in the market, both internal and international. As a response to the pressure, the employers were forced to adapt much faster to the new needs at the market of goods and services. Adaptation implied introducing new technologies, production processes and service provision, as well as new methods of work organisation. The need to design changes i.e. innovations or adaptation to changes in much shorter intervals led to a certain paradox. Namely, the variability respectively adaptability became a permanent characteristic (a constant) of all employers that thrive to survive in the market. The introduction of changes necessarily reflects both the required number and the structure of the workforce. Employers can directly influence some parameters in the business with their decisions and procedures, but some parameters are simply outside their powers and capabilities. One of these parameters are labour rights and rights related to labour, that are mostly regulated by the norms of the state's protection legislation. The state or the competent public authority is forced to redefine the labour standards that were established in the era of Fordism under the pressure of employer's competitiveness as holders of the economic system. As Oladeinde (2008) said, the measures that were initially designed to protect the employees are now seen as primary «obstacles» for economic growth (p. 56).

Redefining and adaptation of labour standards by removing the «obstacles» on the way to a more efficient business is perceived as flexibilisation of employment. Flexibility has several forms, and one of the classifications is as follows: numeric flexibility, functional flexibility and flexibility of earnings. Additionally, numeric flexibility is divided into internal and external. According to Pacelli and others (European Foundation for the Improvement of Living and Working Conditions, 2010, p. 48) part of the scheme covering flexibility would read as follows:

	Employment security
External numeric flexibility	Types of employment contracts Labour protection legislation Early retirement
Internal numeric flexibility	Reduction of weekly working hours /part-time employment
Functional flexibility	Enrichment of the work, i.e. employment opportunities Training Labour force renting Subcontracting Outsourcing



Labour costs/flexibility of earnings	Local adaptation of labour costs Gradation or reduction in social welfare (insurance) payment.
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Typical forms of external or contractual flexibility reflect in the possibility to enter a fixed-term employment, part-time employment, homework employment, employment with probation period and employment with a trainee. The dismissal protection legislation is particularly estimated within this kind of flexibility.

Internal flexibility means the possibility of scheduling working hours and tasks according to the needs of the employer as well as the employees.

This paper will present and analyse legislative framework on external flexibility in Bosnia and Herzegovina (BiH), namely the Federation BiH, the Republika Srpska and Brčko District BiH. The legislative framework of external flexibility in Bosnia and Herzegovina regulates the fixed-term employment, part-time employment, homework employment, and employment with probation period, as well as the dismissal protection legislation. Temporary Employment Agencies, as an essential element in the analysis of flexibility, will not be elaborated, as these are not yet legally regulated in the labour legislation of Bosnia and Herzegovina. Labour legislation at the BiH state institutions' level will not be elaborated in this paper either as it is only applicable to the state institutions of Bosnia and Herzegovina as employers, with the minor exemption, that are referring to the associations or foundations that are non-profit according to the law.

## 1. EMPLOYMENT FLEXIBILITY IN BOSNIA AND HERZEGOVINA

The labour legislation of Bosnia and Herzegovina was an integral part of the legal system of the Socialist Federal Republic of Yugoslavia (SFRY) from the end of the Second World War to the beginning of the 1990s of the twentieth century. This time frame largely coincides with the period of Fordism in Western Europe. The legislation is mostly characterized by the socialist business model, with social property and planned production. The employees were usually employed on a full-time basis for an indefinite period. The employment was regulated in detail with ensured high level of safety at work and employment security (Dedić & Gradašević-Sijerčić, 2005, p. 29-33; Lubarda, 2013, p.190-194). After the dissolution of SFRY and signing of the Dayton

Peace Agreement in 1995, the labour legislation in Bosnia and Herzegovina is adopted according to its constitutional establishment. Specifically, the labour legislation of Bosnia and Herzegovina is comprised of the legislation adopted and applied in the Federation of Bosnia and Herzegovina (FBiH), Republika Srpska (RS), Brčko District of Bosnia and Herzegovina (BD BiH), and the labour law applicable to the BiH state institutions' level. This means the labour legislation of Bosnia and Herzegovina is characterised by several types of laws that regulate rights, obligations and responsibilities in the employment: laws of Bosnia and Herzegovina, laws of FBiH, laws of RS, laws of BD BiH, as well as laws passed by the Office of the High Representative (Gradašćević-Sijerčić, 2005, p. 195; Gradašćević-Sijerčić, Rizvić & Obradović, 2007, p. 12).

First modern labour laws, with series of subsequent amendments, within the market-based economy, were passed in the Federation BiH in 1999<sup>3</sup>, in the Republika Srpska and Brčko District BiH in 2000<sup>4</sup>, and at the BiH state institutions' level in 2004<sup>5</sup>. In the context of employment flexibility, these laws largely incorporated the solutions from secondary sources of the European Union (EU) laws that are related to the content of the employment contract<sup>6</sup>, fixed-term contract<sup>7</sup>, part-time employment contract<sup>8</sup>, and organization of working time<sup>9</sup>.

Despite the legal solutions enabling a significant level of employment flexibility, there is still a certain negative perception about their application, in particular by the employers. The employers still find the labour legislation an obstacle to their business and adaptation to new circumstances at the market. Consequently, in early 2015, upon the initiative of the foreign affairs ministers of Great Britain and Germany, all levels of authority in Bosnia and Herzegovina adopted the Reform Agenda for the period of

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<sup>3</sup> Labour Law of Federation of BiH. Official Gazette FBiH, 43/99, 32/00 and 29/03

<sup>4</sup> Labour Law of Republika Srpska. Official Gazette RS 28/00, 40/00, 47/02, 38/03, 66/03, 20/07 and 55/07 - consolidated text, Labour Law of Brčko District BiH. Official Gazette of Brčko District BiH 7/00, 08/03, 33/04, 29/05, 19/06- edited text, 19/07, 25/08, 20/13, 31/14 and 1/15- hereinafter: Labour Law BD BiH

<sup>5</sup> Labour Law in institutions of Bosnia and Herzegovina. Official Gazette BiH 26/04, 7/05, 48/05, 60/10 and 32/13

<sup>6</sup> COUNCIL DIRECTIVE 91/533/EEC of 14 October 1991 on an employer's obligation to inform employees of the conditions applicable to the contract or employment, OJ L 288, 18. 10. 1991

<sup>7</sup> COUNCIL DIRECTIVE 1999/70/EC of 28 June 1999 concerning the framework agreement on fixed-term work concluded by ETUC, UNICE and CEEP, OJ L 175, 10. 7. 1999.

<sup>8</sup> COUNCIL DIRECTIVE 97/81/EC of 15 December 1997 concerning the Framework Agreement on part-time work concluded by UNICE, CEEP and ETUC, OJ L 014, 20. 01. 1998.

<sup>9</sup> DIRECTIVE 2003/88/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 4<sup>th</sup> November 2003 concerning certain aspects of the organisation of working time, OJ L 299, 18. 11. 2003.

2015-2018. The objective of the Agenda is to implement series of reforms in different areas in order to improve the business environment for domestic and foreign investments and to strengthen the economic capacities of the country.<sup>10</sup> As for the labour market, the Agenda highlights that: “existing labour laws do not reflect social and economic relations in BiH anymore, some provisions are in contradiction with other laws and some of them are unclear and insufficiently flexible. The culture of collective negotiations and social dialogue is insufficiently developed and often burdened with unrealistic demands of social partners”.<sup>11</sup> In order to make the labour legislation more flexible, within the labour market reform, new labour laws were passed in the Republika Srpska<sup>12</sup> and in the Federation BiH<sup>13</sup> in early 2016.

## 2. FIXED-TERM CONTRACT

From the employer’s standpoint, the fixed-term contract, is one of the most important manifestations of the employment flexibility. Primarily because, once the fixed-term contract expires, the employer is not bound with the employment termination procedures, and in some cases with the obligation to pay severance to the employee.

The second reason why employers need this type of contract is that they face two types of uncertainties when employing new employees: quantitative and qualitative uncertainty. The quantitative uncertainty is the inability to perfectly predict the workforce needed in the future. This is the reason the employer needs numeric flexibility in regard to the number of working hours, and the adequate number of employees. On the other hand, qualitative uncertainty comes from the fact that employers are incapable of fully observing the worker's capabilities in full capacity. As a result, they need the flexibility to dismiss employees who do not meet the needs

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<sup>10</sup> Those are the following: 1) public finances, taxation and fiscal sustainability, 2) business environment and competitiveness, 3) labour market, 4) social welfare and pensions reform, 5) rule of law and good management, and 6) public administration reform.

<sup>11</sup> Text of Reform Agenda for BiH for period 2015-2018, see: <http://fbihvlada.gov.ba/pdf/Reformska%20agenda.pdf> (accessed on 09. 04. 2017)

<sup>12</sup> Labour Law Republika Srpska. Official Gazette RS 1/16 and 66/18- hereinafter: Labour Law RS,

<sup>13</sup> Labour Law Federation BiH. Official Gazette FBiH 26/16 and 89/18- hereinafter: Labour Law FBiH. New Labour Law in Federation BiH was adopted in mid-2015 (published in Official Gazette FBiH 62/15), however it was, on the basis of decision of the Constitutional Court FBiH U- 29/15 from 17 Feb 2016, published in Official Gazette FBiH 20/16 from 16 March 2016, unconstitutional, namely, as the Decision reads, it is to be considered as not adopted.

of their company. The legally prescribed probationary periods are often too short for employers to evaluate their employee's qualities (De Graaf- Zijl, 2005, p. 2.).

All four labour legislations in BiH regulate the fixed-term contract in a different manner. In the Federation BiH employers have full freedom to decide whether to conclude this type of contract with the employee. However, in order to prevent misuse from the employer, the duration of the fix-term contract is limited up to three years. If the employee renews the fixed-term contract with the same employer exclusively or impliedly, or explicitly or impliedly concludes successive fixed-term contracts, for a period longer than three years with the same employer, such contract will be deemed as contract concluded for indefinite period.<sup>14</sup> The Law stipulates what is not considered as an interruption in terms of conclusion of successive employment contracts for a certain period of time<sup>15</sup>.

In the Republika Srpska, employer and employee may conclude a fixed-term contract only in specific cases determined by the Labour Law: for a work that has a predetermined duration due to objective reasons and that is justified by a specific date, and for execution of a specific task or execution of a predetermined event. They may conclude several contracts for a period that cannot be, with or without interruptions, longer than a total of 24 months. Periods of time shorter than 30 days between two contracts will not be considered as interruptions between successive contracts<sup>16</sup>. In some cases, this maximum duration period may be even longer than 24 months.<sup>17</sup> If such contract was concluded contrary to legal provisions or if the employee remains with the employer at least five days after the expiration of the contract, it shall be deemed as employment for an indefinite period.

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<sup>14</sup> Labour Law FBiH Article 22.

<sup>15</sup> According to Labour Law FBiH Article 23, discontinuance shall not be considered a termination of a labour contract in the following cases:

a) annual leave; b) temporary sick leave; c) maternity leave; d) leave of absence in accordance with the law, collective agreement, Rulebook on labour or labour contract; e) a period between termination of a labour contract and the day of return to job pursuant to the decision delivered by a court or another body, in accordance with the law, collective agreement, Rulebook on labour or labour contract; f) leave of absence approved by employer; g) a period of up to 60 days between labour contracts with the same employer, unless otherwise defined for a longer period by a collective agreement.

<sup>16</sup> Labour Law RS Article 39 para. 1-3

<sup>17</sup> According to Labour Law RS Article 39 para 4 those are the following: 1) temporary substitute for an employee, until employee's return, 2) work on a project with predetermined duration, until the end of project, 60 months the longest, 3) with unemployed person who needs up to five pensionable years as one of prerequisites for age retirement, longest until meeting the prerequisite, in line with regulations on pension and disability insurance

In Brčko District BiH, a fixed-term contract may be concluded in the following situations: seasonal jobs, replacement of temporarily absent worker, working on a specific project, temporary increase of scope of work, and in other situations determined by the collective agreement or rules of procedure. Except for the initial contract – the first one - the employment contract cannot be concluded for the period longer than two years. There is a legal presumption here as well that if such contracts are concluded with the same employer for a period longer than two years without interruptions <sup>18</sup> it shall be considered as the contract for indefinite period<sup>19</sup>.

Based on the brief outline of the normative framework for the fixed-term employment contract, the first conclusion is that domestic employers, and even more so foreign employers, must be very careful when deciding in which part of Bosnia and Herzegovina they will perform their business activity. In addition, employees of the same employer shall be subject to different regimes for concluding such contracts if, at the same time, they have facilities for the production of goods (or the provision of services) in both entities, and the Brčko District of BiH.

The reason for this kind of caution is that there are no interlocal collision norms in Bosnia and Herzegovina between the entities and the Brčko District of Bosnia and Herzegovina, which could be used to determine the applicable law. These norms exist only in the area of status, family and hereditary relations and are contained in the Law on Resolution of Conflict of Laws and Jurisdiction in Status, Family and Hereditary Relations of 1979 that was transferred to BiH from the former SFRY.<sup>20</sup> In the dilemma over the applicable law in the case when the employer's seat is in one entity and the employee's work is performed in another, two different positions can be identified. Namely, the First Instance Municipal Court in Sarajevo and the Second Instance Cantonal Court in Sarajevo in a labour dispute in the Federation of Bosnia and

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<sup>18</sup> a) any absence from work in line with the law, collective agreement, rules of procedure or employment contract, b) paid or unpaid suspension in line with the law, collective agreement, rules of procedure or employment contract, c) period between termination of employment contract and day of return to the position upon decision of a court or other body in line with the law, collective agreement, rules of procedure or employment contract, d) absence from work with employers approval, e) period of 15 days the most between contracts with the same employer, unless stipulated otherwise by collective agreement.

<sup>19</sup> Labour Law BD BiH Articles 12 and 13

<sup>20</sup> Official Gazette of SFRJ 9/79 and 20/90. In Bosnia and Herzegovina, this Law has been taken by the Decree on the Law on the Takeover and Application of Federal Laws Applied in Bosnia and Herzegovina as Republican Regulations. Official Gazette of RBiH no. 2/92, and based on this Regulation it is applied in the Federation of BiH. In the Republika Srpska this Law is applied on the basis of the Constitutional Law for the Implementation of the RS Constitution, RS Journal no. 21/92

Herzegovina have taken the stand that in the decision-making on labour rights and obligations, the legislation of the Republika Srpska was the applicable one if the work is performed in its territory. However, the Supreme Court of the Federation of Bosnia and Herzegovina in the same labour dispute on the occasion of the declared revision to the second instance verdict took the position that the law of the Federation BiH was the applicable law in case at hand, explaining its argumentation by the fact that the labour contract was signed at the employer's seat in the Federation BiH, even though the work was performed in the employer's affiliate, placed in the Republika Srpska. As an additional argument, the Supreme Court of the Federation of Bosnia and Herzegovina states that the branch of the employer in Republika Srpska has no legal personality.<sup>21</sup> This legal gap as a result of the lack of interlocal collision norms, and as stated by Meškić (2017), should be regulated at least in the transitional final provisions of the law in the relevant civil law domains relations, including employment relations, until the adoption of the law on interlocal law enforcement in Bosnia and Herzegovina (p. 2).

### **3. PART-TIME EMPLOYMENT CONTRACT**

In this type of contract, the working hours are the flexible element. The contract may be concluded for an indefinite period or as a fixed-term contract. The employment contract defines, apart from the mandatory elements, the number of working hours during which the employee is at disposal to the employer. By using these contracts, the employer utilises its resources in a more rational manner, because the employer utilizes human work in the exact amount that is needed. In this way, similar to the fixed-term employment, the employer has a "manoeuvring" space to estimate how much resources are needed and what time it takes for the employer to adapt to new market challenges.

The Article 1 of the International Labour Organization-ILO Convention 175<sup>22</sup> on part-time work from 1994 determines that the term part-time employee means an employed person whose normal hours of work are less than those of comparable full-time

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<sup>21</sup> See the judgment of the Municipal Court in Sarajevo no. 65 0 Rs 233115 12 Rs from 29 August 2013; the Cantonal Court judgment in Sarajevo no. 65 0 Rs 233115 13 Rsž of 25 May 2016; the judgement of the Supreme Court of the Federation BiH no. 65 0 Rs 233115 16 Rev of 31 August 2017

<sup>22</sup> Bosnia and Herzegovina ratified ILO Part-Time Work Convention (No 175) on 18 Jan 2010.

employees. The term comparable full-time employee refers to a full-time employee who:

- has the same type of employment relationship;
- is engaged in the same or a similar type of work or occupation; and
- is employed in the same operation or, when there is no comparable full-time employee in that operation, in the same company or, when there is no comparable full-time employee in that company, in the same branch of activity, as the part-time employee concerned.<sup>23</sup>

Labour legislations in BiH provide the employer with an opportunity to conclude a part-time employment contract with an employee for an indefinite or fixed-term period.<sup>24</sup> The employee may conclude several such contracts until reaching a full-time norm. There is no bottom limit in the Federation BiH and Brčko District BiH for working hours for such a contract. In the Republika Srpska, there is a bottom limit of ¼ of weekly full-time working hours<sup>25</sup>.

The employees who have concluded a part-time employment contract have all the rights as the full-time employees, except for those rights that depend on the length of the working hours (salaries, compensations, etc.). If the employer concludes a part-time employment contract with the employee for an indefinite period, the flexibility of such employment is limited since the employer is obliged to use the procedures on the contract termination and severance payments in a specific case. One of the outstanding questions is whether the employee could conclude such contract with several employers in the Federation BiH, the Republika Srpska and Brčko District BiH as well. Although formally there is a legal possibility that a worker concludes a part-time employment contract with an employer whose headquarter and facilities are in the Federation BiH, and a part-time employment contract with an employer whose headquarter and facilities are in the Republika Srpska, the worker could hardly have certain rights in full scope guaranteed by each legislation individually. The difficulties in exercising full rights derive from the fact that two distinct employment regimes with differently regulated rights would be applicable. An example of a different arrangement in the Labour Law of FBiH and the Labour Law of RS can be found in: fixed-term contract, the use of annual leave, paid leave, birth leave, etc. The possibility that two different employment regimes apply to the part-time work of one person in

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<sup>23</sup> See full text of Convention at [www.ilo.org](http://www.ilo.org)

<sup>24</sup> Labour Law FBiH Article 36, Labour Law RS Article 41, Labour Law BD BiH Article 23.

<sup>25</sup> Full-time employment length in all legislations is 40 hours a week.

the territory of BiH is also a result of the previously elaborated absence of interlocal collision norms.

#### **4. HOME-WORK EMPLOYMENT**

The main characteristic of this type of employment is that the place of work is not determined by the employer, which is commonly related to its headquarters, or facilities or locations where employer's activities take place. The place of work, in this case, could be the employee's home, or some other space the employee foresees for that purpose. In 1996 ILO has adopted the Convention 177 on Home Work Employment, which entered into force in the year 2000. Bosnia and Herzegovina ratified this Convention in 2010. Article 1 of the Convention clarifies the terminology on home work employee.<sup>26</sup>

The home-work employment contract defines, apart from labour contract mandatory elements, additional rights and obligations for both the employer and the employee, that must be agreed by both contract parties, if the work is done outside the employer's facilities. Those are: 1) working hours, 2) type of task and the method for organizing work, 3) working conditions and the method of supervising work, 4) salary for the work performed and payment terms, 5) use of the employee's own means for work and reimbursement of costs for their use, 6) refund of other costs associated with the performance of tasks and the methods for their determination, and, 7) other rights and obligations. The home-work employment contract may be concluded only for the jobs

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<sup>26</sup> For the purposes of this Convention:

- (a) the term home-work means work carried out by a person, to be referred to as a homemaker,
  - (i) in his or her home or in other premises of his or her choice, other than the workplace of the employer;
  - (ii) for remuneration;
  - (iii) which results in a product or service as specified by the employer, irrespective of who provides the equipment, materials or other inputs used, unless this person has the degree of autonomy and of economic independence necessary to be considered an independent worker under national laws, regulations or court decisions;
- (b) persons with employee status do not become homeworkers within the meaning of this Convention simply by occasionally performing their work as employees at home, rather than at their usual workplaces;
- (c) the term employer means a person, natural or legal, who, either directly or through an intermediary, whether or not intermediaries are provided for in national legislation, gives out home work in pursuance of his or her business activity. Article 1 Home Work Convention (No 177)



which are not hazardous or detrimental to the health of the employee or other persons, and do not threaten the working environment.<sup>27</sup>

This type of employment may be concluded for indefinite or fixed-term period, full-time or part-time. Aside from these types of flexibilisation, an additional element of flexibility is that the employer and the employee agree on the usage of working means and related expenses. In that way, the obligation of obtaining the working means and providing working conditions is transferred from the employer to the employee, understandably with appropriate compensation. This does not imply some sort of partnership relation in which the employee is an independent entrepreneur (self-employed) who signs a business contract with the employer. The basic reason for conclusion of the employment contract, and not a business contract, is that the employer does not order a final product, but the employee produces that product in accordance with employer's orders and instructions and under constant supervision. Therefore subordination (working upon orders and instructions of another person) is accomplished, which is one of the main characteristics of working in an employment relationship. Persons with autonomy and economic independence are required to be independent workers/self-employed, as defined by the ILO Convention no. 177, and are not considered workers who work outside the employer's premises (Homeemployee). These persons, as stated by A.C. Davies (2018), who are running their own businesses do not need the protection of the aforementioned Convention (p. 910).

## **5. EMPLOYMENT CONTRACT WITH PROBATION PERIOD**

Probationary work is not a mandatory part of the employment contract. Probationary work may be integral part of the employment contract for indefinite or fixed-term period, full or part-time work. In the Federation BiH, the probationary period may last 6 months at the most. In the Republika Srpska, the probationary period may last up to three months, but exceptionally, this period can be extended for another three months. Also, in the Republika Srpska the employer and employee may conclude a special probationary employment contract instead of a probationary work clause in the employment contract, and a regular employment contract afterwards, if the employee performs satisfactory in the probationary work. In Brčko District BiH, the probationary

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<sup>27</sup> Labour Law FBiH Article 26, Labour Law RS Article 44, and Labour Law BD BiH Article 15a

period cannot be longer than six months. However, it may be extended and renewed by mutual agreement for another consecutive period of six months so that it lasts for twelve months continuously.

The employer may terminate the employment contract with the employee before the expiration of the probationary period if the employee does not show satisfactory level of knowledge, skills and effort required for a specific job. In that case, the employer is obliged to comply with the seven-day notice.

In the Republika Srpska, the assessment of working ability and the commitment of the worker is performed, on behalf of the employer, by a particular person who must have the qualification and the professional degree, at least as a person who is supervising, as well as the work experience in those jobs.<sup>28</sup>

The employment probationary period contract may, for its legal status, be considered as a contract with a precondition. The precondition would be the unsatisfactory or negative rating of the workers' ability, or the employer's commitment at work. If the employer makes a negative assessment of the employee, then the respective condition is fulfilled and, based on that, the employment contract is to be terminated. If the rating of a worker's work ability or job placement given by an employer is positive, then it is considered that the precondition has not been fulfilled. Hence, the employment contract remains in force.

## **6. DISMISSAL PROTECTION LEGISLATION**

Dismissal protection legislation is regulated by the conditions and procedures that need to be followed during termination of employment. The need for previously elaborated atypical forms of employment is estimated by the employer, based on the needed number and structure of labour force in the future short and long-term period. In this way, especially by using fixed-term contracts, the employer can adjust the number of employees to the needs of the production process or other activities in a short period of time and for a specific period.

On the other hand, if new circumstances, in most cases negative and longlasting by their nature, affect the market of goods, capital and services, the employer is obliged to reduce its activities in the shortest possible timeframe. It can be assumed that the

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<sup>28</sup> Labour Law FBiH Article 21, Labour Law RS Article 37, and Labour Law BDBiH Article 11

circumstances do not necessarily have to be negative for the employer, such as introducing new technology. Both situations, in the first and the second case, have the consequence of a reduced need for workforce, and the employer will be forced to terminate labour contracts to a smaller or a large number of workers. As a result of the pressure, primarily the financial one, it is in the interest of employer to terminate employment of redundant employees with as little financial burden as possible, and in accordance with the simplest possible legal procedure. In this case, the complexity of the dismissal procedure and the employer's financial burden reflect the flexibility of the labour legislation.

Labour laws in the Federation BiH, Republika Srpska and Brčko District BiH stipulate the reasons for termination of the employment contract. The reasons are common for all three laws: 1) due to the death of an employee, 2) when the employee reaches 65 years of age and 15 years (FBiH and RS) of pension insurance coverage, namely when the employee meets the conditions for retirement (BD BiH), 3) mutual agreement between employer and employee, 4) termination of employment contract by the employee or employer, 5) based on the competent court decision, 6) expiration of the fixed-term contract duration period<sup>29</sup>.

Termination of the employment contract by the employer, which is from the employer's point of view the most important method of termination of an employment relationship, is regulated by the aforementioned legislation, providing reasons for termination, form of termination, notice periods and severance payment.

The reasons for termination of the employment contract by the employer may be divided into two groups. In the first group, the employer may terminate the contract of the employee if: 1) the termination is justified for economic, technical or organizational reasons and 2) if the employee is not able to perform his employment duties. The employee cannot be dismissed during pregnancy, maternity leave, parental leave, and working part-time in order to caretake of a child<sup>30</sup>. The employment contract of an employee with altered work capacity (person with certain percentage of disability – the second category of disability in accordance with the laws on pension and disability insurance)<sup>31</sup> may be terminated but only after the

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<sup>29</sup> Labour Law FBiH Article 94, Labour Law RS Article 175, Labour Law BD BiH Article 72.

<sup>30</sup> Labour Law FBiH Article 60, Labour Law RS Article 183 para 2, Labour Law BD BiH Article 73 para 2

<sup>31</sup> Second category of disability or a changed work capability exists when a worker, after their work ability has been assessed by an authorized medical institution, is no longer able to perform the jobs and tasks of their workplace, but can complete the jobs and tasks of another workplace in full time, with

consultations with the union or workers council.<sup>32</sup> In the Federation BiH and the Republika Srpska, the employer may terminate the employment contract for the reasons provided in the first group only after they tried to ensure the employee another position suited to the employee's expertise, or to provide the employee with education or training for work at another position. After terminating the employment contract, if the employer wants to fill in that position again within one year after the termination, the employer shall offer the position to the former employee. All three labour laws prescribe the obligation to set up a redundancy programme in the event of employer's dismissal of a large number of employees in a short period of time. During the preparation of the redundancy programme, the employer is obliged to consult the union and the workers council. The redundancy programme identifies the number of workers and the reasons for their dismissal and the extent to which such workers may possibly be employed in other positions, with the same or another employer, with or without additional education and training<sup>33</sup>.

In the second group of reasons, the employer may terminate the employment contract if an employee commits a disciplinary misdemeanour which is a severe violation of work commitments or work discipline. In the Federation BiH, the collective agreement or rules of procedure stipulate which actions constitute a serious violation of work commitments arising from the contract or provisions on discipline. In the Republika Srpska and Brčko District BiH, these violations are stipulated in the Labour Law.<sup>34</sup> If the contract is terminated due to disciplinary action, the employee has the right to a hearing. Termination periods as a result of a disciplinary misdemeanour are different in all three laws.<sup>35</sup>

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possible additional re-qualification or the qualification. The second category of disability is defined in Art. 48 of the Law on Pension and Disability Insurance of the Federation of Bosnia and Herzegovina (Official Gazette FBiH 13/18).

<sup>32</sup> In Brčko District BiH, this approval is given by the Labour Inspector. In Republika Srpska, persons who suffered an injury at work or got a professional illness assessed by an authorized medical body may receive the termination notice only with their written consent. Labour Law FBiH Article 74, Labour Law RS Article 117, Labour Law BD BiH Article 55 and 56.

<sup>33</sup> Labour Law FBiH Article 109 and 110, Labour Law RS Article 160-166, Labour Law BD BiH Article 83 and 84.

<sup>34</sup> Labour Law FBiH Article 96 and 97, Labour Law RS Article 179, Labour Law BD BiH Article 73, 74 and 74a.

<sup>35</sup> In Federation BiH, the period is 60 days from the execution of the disciplinary act, or upon cognition of its execution, but one year from execution the longest. In Republika Srpska, the period is 3 months after the execution of the act or cognition of its execution, 6 months after the execution the latest. In Brčko District BiH, the period is 30 days upon cognition of the execution.

The employer hands over to the employee a termination notice in writing; thus, providing and explaining the reasons for dismissal. The written form and appropriate explanation are significant from both perspectives - employer's and employee's - and in particular for filing complaints as a part of the internal protection of the employee's rights, and for filing an appeal and initiating a dispute before the competent court.

When cancelling an employment contract, the employer is obligated to comply with the cancellation notice period. In the Federation BiH this notice period is a minimum of 14 days, and it could be extended to maximum of 3 months by collective agreement or employment contract. The notice period cannot be shorter than 14 days in Brčko District BiH, and 30 days in the Republika Srpska, without maximum limit of the period.<sup>36</sup> If the employer is terminating the employment contract as a result of disciplinary misdemeanour, that constitutes a serious breach of their working duties or work discipline, then the worker shall not be entitled to the notice period

The employer is obliged to pay the severance pay to the employees whose employment contracts were terminated as a result of the economic, technical or organizational reasons, or if the employee is no longer able to perform its work duties and commitments (the first group of reasons), under legally prescribed conditions. Those conditions are: 1) they have indefinite period employment contract, and 2) the employment contract is terminated after at least 2 years of consecutive work. The severance pay is determined by collective agreement, rules of procedures or employment contract. The labour laws stipulate that it can not be lower than one-third of the average monthly salary, paid to the employee in the last three months before the termination of their labour contract, for each full year of employment with that employer. Maximum severance pay is determined in the Federation BiH and the Republika Srpska, and it cannot exceed six average monthly salaries paid to the employee in the last three months prior to termination of the contract. The employee and employer may agree on another type of compensation instead of severance pay.<sup>37</sup> If the contract is terminated for the employee with altered work capacity, the amount of severance pay is increased for 50% in the Federation BiH and 100% in the Republika Srpska<sup>38</sup>.

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<sup>36</sup> Labour Law FBiH Article 105, Labour Law RS Article 192, Labour Law BD BiH Article 80.

<sup>37</sup> Labour Law FBiH Article 111, Labour Law RS Article 194, Labour Law BD BiH Article 85.

<sup>38</sup> Labour Law FBiH Article 74, Labour Law RS Article 118.

## 7. CONCLUSION

The competitiveness of employers in performing their economic activities at the beginning of the 21st century depends to a large extent on the possibilities of adaptation to newly emerging circumstances as a result of the globalisation process. For the purposes of adapting, some of the business components - such as introducing new technologies, innovation in manufacturing or providing services, as well as marketing, etc., - can be affected by the employers. On the other hand, labour costs that are manifested through the obligation to comply with the norms of state labour protection legislation are a component which employers can not independently influence. That is why competent public authorities have introduced flexibility of labour relations, with the aim of strengthening the employer's competitiveness in national and international frameworks. Flexibility of work relationships is assessed as external and internal.

The scope of external flexibility in the labour legislation of Bosnia and Herzegovina, which was the subject of this paper, is usually assessed through the ability to conclude fixed-term employment contracts, part-time employment contracts, home work employment contracts, employment contracts with probationary period, and a special form of external flexibility that is connected to the dismissal protection legislation.

Labour legislation of Bosnia and Herzegovina is comprised of regulations that are adopted and applied in the Federation BiH, the Republika Srpska and Brčko District BiH, and at the BiH state institutions level. The dispersion of legislation and different regulation of legal institutes in the labour laws are huge problems for domestic, and also foreign, employers. Namely, this opens the question which labour legislation as a whole makes an employer more competitive in BiH. Even though the solutions in labour legislation in BiH are mostly, from the perspective of flexibility, harmonized with the EU legal system standards, there are four employment relationship regimes that exist simultaneously in a relatively small geographical area. Employers (both domestic and foreign), apart from other administrative and financial parameters, must carefully estimate which employment regime puts them in a more advantageous position in business.

After analysis of flexibility forms in labour legislation in Bosnia and Herzegovina, three conclusions can be drawn.

Firstly, the most harmonized flexibility forms in all three reviewed legislations are an employment relationship with part-time working hours (with stipulated bottom limit in the Republika Srpska) and home work employment relationship. All other institutes are regulated differently by including different exceptions, limits, periods, etc.

Secondly, because of the possibility to establish employment for a fixed-term period based solely on free assessment (discretionary assessment) of the employer without any prescribed legal conditions, it can be concluded that labour legislation of the Federation BiH is more flexible in comparison to the legislations of the Republika Srpska and Brčko District BiH.

Thirdly, the dismissal protection legislation in all three legislations obliges the employer to terminate the employment contract only after meeting all legally proscribed requirements. The termination notice must be in writing and with an explanation. Additional obligation of the employer is to respect the notice periods and pay the severance in legally stipulated situations. From the aspect of flexibility, at least in short-term period, projection of required labour force is crucial for the employer, so employees can be hired through fixed-term contracts or part-time employment contracts. In this way, the employer will avoid the obligation of following legally stipulated reasons and procedures for termination of employment, which may cause huge financial burden. On the other hand, the employer should also be careful whether to insist only on these flexible forms of employment when scouting for employees, since quality employees might seek another employment when they recognize this tendency.

Employment flexibility should not and must not be perceived as a derogation of achieved labour standards. Employment for indefinite period as a main source of livelihood of employees currently is and should be, in the future, the dominant employment form. The flexibility is a necessity that should enable employers to easily adjust to the new circumstances, which will help preservation of existing jobs, and creation of preconditions for new jobs.

In the end, although the flexible forms of employment have been part of the labour laws in Bosnia and Herzegovina for the last 15 years, without simultaneous and adequate reforms of other systems (administrative, fiscal, etc.), flexibility will stay an important, but not decisive factor for competitiveness of employers.

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## **COMPETITIVE ASSESSMENT OF “HUB AND SPOKE COLLUSIONS” FROM EUROPEAN UNION AND TURKISH COMPETITION POLICY PERSPECTIVE**

**Mehmet Fatih Arici \* §**

### **SUMMARY**

*The recent competition law phenomenon known as hub and spoke collusions, are not regulated under either European Union (EU) or Turkish competition law regime. A hub and spoke collusion is basically a way of coordination reached through a third party, which usually is an upstream or a downstream player, rather than a direct communication among the participants.*

*The exchange of competitively sensitive information among undertakings could potentially increase transparency in the market and facilitate coordination among participants. Since the exchange of sensitive information through direct communication among competitors is prohibited, and competition authorities have a strict approach in this regard, undertakings may tend to use a third-party for the information flow in order not to attract any attention of the competition authorities. Therefore, the information flow among competitors through third parties need a special attention.*

*The hub and spoke phenomenon, which is commonly known as “collect/distribute type infringements” or “ABC information exchange” in Turkish literature, will be the focus of this study. We will evaluate the legal framework of this recent phenomenon that is mostly shaped by the court practices and the limited literature from a competition policy perspective.*

### **INTRODUCTION**

All agreements between undertakings which have as their object or effect the restriction of competition are prohibited both under EU and Turkish competition law. These principles are stated in Article (Art.) 4 of the Turkish Act on the Protection of Competition numbered 4054 (TAPC) and Art. 101 of the Treaty on the Functioning of

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the European Union (TFEU). These regulations in principle prohibit bilateral conduct, and not the unilateral conduct of the undertakings.

Prohibited agreements are not subject to any form or validity conditions and are not expected to be applied so long as a meeting of undertakings is established. Art. 101 of TFEU and Art. 4 of TAPC are applicable to both horizontal and vertical agreements. In general, agreements in competition law are divided into two types: Horizontal and vertical agreements. Horizontal agreements are established between undertakings competing on the same market and may be formed to fix price, allocate customers and markets, reduce output and variety or quality of the goods. However, vertical agreements are concluded between undertakings which are active in a different level of production or distribution chains. Vertical agreements are generally less harmful than horizontal agreements and the *rule of reason* analysis applied to the former one<sup>1</sup> (Sahuguet & Walckiers, 2017, p. 354; Sanlı, 2000, p. 73 ff.; Akıncı, 2001, p. 42 ff.; Topçuoğlu, 2001, p. 132 ff.; Ari, 2004, p. 39-49; Güven, 2008, p. 125-138). TFEU Art. 101/1 and TAPC Art. 4 also prohibit concerted practices which do not reach the level of agreement. However, they facilitate coordination between undertakings (see also Colino, 2011, p. 219 ff; İkizler, 2005, p. 57 ff.; Cengiz, 2006, p. 13 ff.).

A hub and spoke collusion involves the exchange of sensitive information between competitors via vertical relationship to create a horizontal restriction<sup>2</sup> (Vereecken, 2015, p. 3; Lubambo, 2015, p. 139-140; Orbach, 2016, p. 1; Falls & Saravia, 2015, p. 9). Taken from the concept of the bicycle, the common supplier is analogized to the “hub” of a wheel, its vertical agreements with retailers are analogized to the “spokes” of a wheel, and a horizontal agreement among the retailers is analogized to the “rim” of a wheel. This collusive conduct is also called ABC (A to B to C) information exchange (Sahuguet & Walckiers, 2017, p. 354). The main problem associated with this anti-competitive conduct mostly arises from the uncertainty associated with the

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<sup>1</sup> Dissimilarly with American Law, the concept of *rule of reason* in EU competition law is a relatively controversial issue. For further information see Jones & Sufrin, 2016, p. 183-185; Whish & Bailey, 2012, p. 134-136; Ata, 2009, p. 29-30.

<sup>2</sup> According to the Horizontal Guidelines of European Commission: “(t)he exchange of market information may also lead to restrictions of competition in particular in situations where it is liable to enable undertakings to be aware of market strategies of their competitors”. See Communication from the European Commission, Guidelines on the Applicability of Article 101 of the Treaty on the Functioning of the European Union to Horizontal Co-operation Agreements (2011) OJ C 11/1, para. 55 (Hereafter: Horizontal Guidelines).

categorization of these behaviours as horizontal or vertical agreement (Doğan, 2017, p. 412).

At this exact point, three important issues concerning Turkey’s competition law regime need to be flagged up: *Firstly*, unlike EU competition law, ‘*presumption of concerted practice*’ has been accepted by the TAPC (Art. 4/3, 4). This presumption may be useful for the purpose of revealing hub and spoke collusions. *Secondly and more importantly*, “cartel” description in Turkish law covers quite a wide frame. A cartel is described as “*agreements restricting competition and/or concerted practices between competitors for fixing prices; allocation of customers, providers, territories or trade channels; restricting the amount of supply or imposing quotas and bid rigging*” (the Regulation on Fines to Apply in Cases of Agreements, Concerted Practices and Decisions Limiting Competition and Abuse of Dominant Position, Art. 3/1-ç; Regulation on Active Cooperation for Detecting Cartels (“Leniency Regulation”) Art. 3/1-c). Cartel is being described in such a manner as to cover both agreements, and concerted practices may be useful in terms of the categorization of hub and spoke. *The third point*, which is in connection with the definition of the cartels under Turkey’s competition law, is that this categorization is essentially important for the leniency programmes since only “cartels” are covered by the Leniency Regulation, while the vertical agreements are excluded from the scope (Leniency Regulation, Art. 6).

## **1. LACK OF DEFINITION UNDER EU AND TURKISH COMPETITION LAW**

Hub and spoke collusions are not regulated directly under the legal regimes of either the EU or Turkey’s competition law. The rules on the anti-competitive agreements and concerted practices are applicable to the hub and spoke collusions (TFEU Art. 101; TAPC Art. 4).

Horizontal guidelines of the European Commission (in para. 55) seem to be helpful in terms of dealing with such type of competition infringements<sup>3</sup>: Paragraph 55 reads as follows: “*Secondly, data can be shared indirectly through a common agency (for example, a trade association) or a third party such as a market research organisation or through the companies’ suppliers or retailers*”. The guidelines do not include any special criterion regarding the characteristics and components of hub and spoke. Hub and spoke is

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<sup>3</sup> Also see Turkish Guidelines on Horizontal Cooperation Agreements para. 40 ff and Altun, 2012, p. 16 ff.

rather included within the concept of indirect information exchange and is a special and featured practice<sup>4</sup>. In the presence of certain conditions, this practice might constitute a breach of competition law in the form of an anticompetitive agreement or a concerted practice.

A recent position taken by the European Competition Network (ECN) on cartels, including vertical elements, is important also for the hub and spoke collusions. The ECN Model Leniency Program covers a cartel with vertical elements<sup>5</sup>. If the hub is a co-perpetrator of a cartel and a fine can be imposed against it, it should be entitled to apply for leniency (See Zampa & Buccirosi, 2013, p. 108).

## 2. CONCEPTUAL FRAMEWORK OF HUB AND SPOKE COLLUSIONS

In competition law literature, hub and spoke are defined as a collusion among undertakings (“spokes”) both in lower and upper markets, through exchange of competitively sensitive information, by a centre-undertaking (“hub”) (Lianos, 2008, p. 1056-1057; Amore, 2016, p. 28; Doğan, 2017, p. 412; Can, 2012, p. 21, fn. 31). From this definition, it can be inferred that there are five elements of a hub and spoke collusion: 1. Hub: A central undertaking as a facilitating element; 2. Spokes: Multiple undertakings which are upstream or downstream firms; 3. A vertical relationship between hub and spokes; 4. Indirect exchange of confidential information including a horizontal element and 5. A connection between spoke firms (“rim/agreement”).

Analytic tools used in evaluation of these elements; *(i.)* knowledge or intent, *(ii.)* facilitation and *(iii.)* an independent coordinated conduct analysis. By using analytic tools, where a horizontal agreement (rim) is founded, vertical participant (hub) may also be found liable for the facilitation of the cartel (Jones & Sufrin, 2016, p. 161), provided that a common anticompetitive object such as price fixing had been determined (Zampa & Buccirosi, 2013, p. 108). When there is an anticompetitive objective among hub and spokes to be found, this should be qualified as cartel and be punished under TFEU Art. 101 and TAPC Art. 4.

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<sup>4</sup> The exchange of information between undertakings is a wider concept than hub and spoke. Information exchange can be carried out in three main ways: Directly, through third parties or open and sharing practices with the public. For detailed information see Pişmaf, 2012, p. 5 ff; Aslan, E. F., 2012, p. 3-79.

<sup>5</sup> Also see the ECN Model Leniency Programme (revised in November 2012) at para. 14, (available at: [http://ec.europa.eu/competition/ecn/mlp\\_revised\\_2012\\_en.pdf](http://ec.europa.eu/competition/ecn/mlp_revised_2012_en.pdf), last accessed: 20.02.2018).

To clarify the situation with an example, let us assume that the supplier (B) collects retailer (A)'s and (C)'s future pricing information, and shares this information with one another. In this case, even if there is no direct communication between (A) and (C), indirect pricing information exchange through (A) might reduce the uncertainty in the market for the competitors and lead to the revelation of future pricing trends/intents. This situation might result in the establishment of a coordination platform between the competitors.

Besides, competitively sensitive information exchange, as part of a horizontal agreement, does not only appear in a form of price information but also in a form of exchange of other information on agreements, as well as information indirectly implying customer or region allocation. In terms of vertical agreements, determination of re-sale price, reseller's region or customer circle and non-compete agreements can set example of exchange of competitively sensitive information.

In our opinion, not all kinds of indirect information exchange, as stated in the Horizontal Guidelines, should be interpreted as part of the hub and spoke concept. For example; collusions arising from the indirect information exchange with members of associations of undertakings should be kept outside of the hub and spoke (See Falls & Saravia, 2015, p. 9, fn. 3). This is because the interests of associations of undertakings are derivatives of the relevant competitors.

This perspective might enlighten the status of the third parties facilitating the indirect information exchange. In fact, the facilitator may be active in a market that has no horizontal or vertical relation with the market where the horizontal collusion is sustained. An undertaking's facilitation of the indirect information exchange does not fall within the scope of hub and spoke (different view in Turkish law see Aslan, 2017, p. 419). For example, a consulting undertaking's facilitation of indirect information exchange among manufactures does not constitute a hub and spoke. This should not be interpreted as if such facilitation does not constitute an infringement from a competition law perspective. Thus, consulting undertakings may be held liable for facilitating the indirect information exchange and other actions constituting their participation in a cartel among manufacturers<sup>6</sup>.

Hub and spoke collusions may also have private law consequences in the form of compensation. Art. 57 of TAPC reads as follows: *“Anyone who prevents, distorts or*

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<sup>6</sup> This also applies to *AC Treuhand I*, see below fn. 21.

*restricts competition via practices, decisions, contracts or agreements contrary to this Act, or abuses his dominant position in a particular market for goods or services, is obliged to compensate for any damages of the injured. If the damage has resulted from the behaviour of more than one people, they are responsible for the damage jointly*". If the necessary conditions are fulfilled, the damaged parties, as a rule, may file a claim for compensation against undertakings forming the hub and spoke (for detailed information see Kesici, 2017, p. 39 ff.).

### **3. TYPES AND INCENTIVES IN HUB AND SPOKE COLLUSIONS**

#### **3.1. Incentives of Hub and Spoke Collusions**

Undertakings may have different incentives for participation in a hub and spoke collusion such as reducing competition, avoidance of punishment by other participant undertakings (hub or spokes), sharing the gain and benefit, increasing or protecting the market share and power (Falls & Saravia, 2015, p. 18). As many horizontal agreements are unlawful among competitors, using an intermediary can be a good choice to avoid attracting any attention of competition authorities (Sahuguet & Walckiers, 2017, p. 355). The fact that it's difficult to establish a horizontal agreement might be the other motive for applying a hub and spoke concept (Cayseele & Miegelsen, 2014, p. 2 ff.; Amore, 2016, p. 33).

The undertakings that are in a hub position can also have the above-mentioned incentives<sup>7</sup>. Besides, it's stated in economic literature that the incentive of hubs for participating in a hub and spoke collusion is not understood adequately (Sahuguet & Walckiers, 2017, p. 354). A hub's incentive for participating in a collusion differs from the spokes in the hub and spoke; a supplier may participate in a hub and spoke collusion in the capacity of the third party with a purpose, completely independent from anticompetitive motives, which are explained in the previous paragraph. There are studies showing that these kind of collusive relations, under certain conditions, can increase both consumer welfare and social welfare (Sahuguet & Walckiers, 2017).

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<sup>7</sup> Potentially there can be some convergent interests of the suppliers and of the distributors (See Zampa & Buccirossi, 2013, p. 97).

### 3.2. Types of Hub and Spoke Collusions

In the literature, hub and spoke collusions are generally categorized under two groups (Zampa & Buccirosi, 2013, p. 91; Amore, 2016, p. 31-32; Doğan, 2017, p. 412-413). This categorization is based on the position of the hub and spoke participants. In the first group, there are vertical agreements among a common provider and more than one retailer or distributor<sup>8</sup>. In this group, a hub and spoke causes the establishment of horizontal collusion in the downstream market. In the second group, the exact opposite of first group occurs as there are vertical agreements between a distributor or retailer in lower market and more than one provider in upstream market<sup>9</sup>. In this group, horizontal collusion occurs among undertakings in the upstream level.

In our opinion, the aforementioned classification fails to include all hub and spoke collusions as more than one undertaking may appear both in lower and upper markets at different levels of the distribution chain<sup>10</sup>. The characteristic feature of all hub and spoke collusions, in which both groups are involved, is the fact that horizontal and vertical elements are in existence all together<sup>11</sup>. This characteristic feature of hub and spoke collusions demonstrates that this sort of infringements has a hybrid structure. The aim of the hub and spoke collusion may be restricting the competition only at spokes, only at hub level or both levels (Falls & Saravia, 2015, p. 10-13).

## 4. HUB AND SPOKE COLLUSIONS UNDER CASE LAW

Hub and spoke is a relatively new phenomenon for Turkey’s competition law and the Turkish Competition Board (Board) has limited precedents in this regard. At EU level, there is a lack of EU case-law directly addressing hub and spoke collusions (Jones & Sufrin, 2016, p. 161). In contrast, in American antitrust case law hub and spoke

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<sup>8</sup> For instance, *Toys and Games, Replica Football Kit, Tobacco and Diary* cases in UK (For cases see Amore, 2016, p. 29, fn. 2).

<sup>9</sup> For instance, *Interstate Circuit, Toys “R” US and E-Book* cases in the USA (Orbach, 2016, p. 6-11; Lubambo, 2015, p. 140).

<sup>10</sup> In this case, the hub and spoke phenomenon is expressed as a “matrix” (Falls & Saravia, 2015, p. 9).

<sup>11</sup> Some authors mistakenly use the concept of “hub and spoke” in a wider meaning as if it is same with “indirect information exchange”, while hub and spoke is a subdivision of indirect information exchange, i.e. indirect information exchange is the main and broader concept including hub and spoke. Compare with Aslan, 2017, p. 418-419.



infringements had been analysed for many years (for more information see Orbach, 2016, p. 6-11; Amore, 2016, p. 37, 40).

In EU law, competition authorities and courts of some member countries have dealt with the matter. Decisions, being milestones were encountered for the first time in the United Kingdom (UK). In the UK, hub and spoke collusions were determined between retailers and manufacturers of sporting goods, toys, dairy products and tobacco<sup>12</sup>.

In the UK, for instance, in two cases best known as *Replica Football Kit* and *Toys and Games*, it has been decided that there is an anticompetitive agreement or concerted practice to determine the minimum retail price for introducing consumer goods to the market<sup>13</sup>. In these cases, there was no direct communication between retailers. The interesting part of those cases is that the Office of Fair Trading (OFT) did not only find two-sided vertical agreements among suppliers and retailers, but it also found horizontal agreements among retailers (Whish & Bailey, 2012, p. 338). These horizontal agreements were formed by the indirect information exchange facilitated by (B) (hub/supplier) among (A) and (C) (spokes/retailers). The facilitation of the aforementioned information exchange reveals the existence of a triangle agreement among (A), (B) and (C), as it was considered that each of these undertakings had been aware of the other's conduct and essence of its intentions concerning its behaviour in the relevant market (See Lianos, 2008, p. 1059; Whish & Bailey, 2012, p. 339). OFT's triangle agreement or concerted practice approach was also accepted by the UK Competition Appeal Tribunal ("CAT")<sup>14</sup>:

The Court, which evaluates objections to appeals, has also adopted triangle agreement or concerted practice in case law<sup>15</sup>. However, the Court has accepted a narrow

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<sup>12</sup> Member states also have hub and spoke cases such as Germany (hearing aids, contact lens), Belgium (chocolate firms), France (snow shoes), Poland (paint and varnish sales) and Italy (cosmetic products). See Van Cayseele, 2014, p. 164; Bolecki, 2011, p. 27 ff.; Zampa & Buccirosi, 2013, p. 91, 92, fn. 3, 4.

<sup>13</sup> UK OFT, 1 August 2003, CA98/06/2003 (*Replica Football Kit*); UK OFT, 2 December 2003, CA98/8/2003 (*Toys and Games*).

<sup>14</sup> UK CAT, *JJB Sport v OFT and Allsports v OFT*, [2004] CAT 17, Case 1021/1/1/03, 1022/1/1/03; UK CAT, *Argos and Littlewoods v OFT*, [2004] CAT 24, Cases 1014 and 1015/1/1/03. Covert threat played a key role to assess the hub and spoke collusion in *Replica Football Kit* (See *JJB Sport v OFT and Allsports v OFT*, [2004] CAT 17, Case 1021/1/1/03, 1022/1/1/03, para. 666-667). Recommended retail price ("RRP") clause was used as a tool to fix the prices in *Toys and Games* (*Argos and Littlewoods v OFT*, [2004] CAT 24, Cases 1014 and 1015/1/1/03, para. 778 ff.). Non-binding RRP clauses are not prohibited in EU competition law, provided that RRP clauses do not amount to a fixed or minimum resale price (See Van Cayseele, 2014, p. 165; Zampa & Buccirosi, 2013, p. 96, 104, 105).

<sup>15</sup> England and Wales Court of Appeal, *Argos and Littlewood v. OFT and JJB Sports v OFT*, [2006] EWCA Civ 1318, Cases 2005/1071, 1074 and 1623, para. 102-145.

definition of hub and spoke. This definition excludes the condition of reasonable foreseeability (constructive knowledge); and has been replaced by actual knowledge condition<sup>16</sup>:

*“If (i) a retailer A discloses to supplier B its future pricing intentions in circumstances where A may be taken to intend that B will make use of that information to influence market conditions by passing the information to other retailers (of whom C is or may be one), (ii) B does in fact, pass that information to C in circumstances in which the information was closed by A to B and (iii) C does, in fact use the information in determining its own future pricing information, then A, B and C are all to be regarded as parties to a concerted practice having as its object the restriction or distortion of competition”<sup>17</sup>.*

It remains debatable whether constructive knowledge (reasonable foreseeability)<sup>18</sup> is sufficient to establish a breach of Art. 101 TFEU until the case *AC Treuhand I*<sup>19</sup>: The General Court of Justice of the European Union (GC) favours “reasonable foreseeability” which means that the attribution of infringement, as a whole, to the participating undertaking depends on the manifestation of its own intention, albeit only tacitly, with the common plan of cartel.

There are also some other ABC cases about indirect exchange of pricing information to identify hub and spoke collusions and to find out legal boundaries of that kind of

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<sup>16</sup> England and Wales Court of Appeal, *Argos and Littlewood v. OFT and JJB Sports v OFT*, [2006] EWCA Civ 1318, Cases 2005/1071, 1074 and 1623, para. 140, 141.

<sup>17</sup> According to the decision of The Court of Appeal, reciprocity makes it easier to find out an anticompetitive hub and spoke agreement. England and Wales Court of Appeal, *Argos and Littlewood v. OFT and JJB Sports v OFT*, [2006] EWCA Civ 1318, Cases 2005/1071, 1074 and 1623, para. 141: “The case is all the stronger where there is reciprocity in the sense that C discloses to supplier B its pricing intentions in circumstances where C may be taken to intend that B will make use of that information to influence market conditions by passing that information to (among others) A and B does so”.

<sup>18</sup> See the discussions on the role of intent and extent of what “knowingly” means: Zampa & Buccrossi, 2013, p. 103-104; Lubambo, 2015, p. 145-147.

<sup>19</sup> GC, Case T-99/04, *AC Treuhand AG v Commission*, ECLI: EU: T: 2008:256, para. 134, 150. AC Treuhand company is a Swiss consultancy firm that found to have contributed to the maintenance of a cartel and got fined for complicity. The Court of First Instance found that the applicant actively contributed to the implementation of the cartel. According to *AC Treuhand I* decision, AC Treuhand shall be sanctioned under 81 Art. EC (Art. 101 TFEU) as a cartel facilitator, irrespective of it not being active on the cartelized market. In the author’s view, *AC Treuhand I* case was not a pure hub and spoke collusion because AC Treuhand was not active on the cartelized market directly or via a common trading partner. See for recidivism by AC Treuhand firm in *AC Treuhand II* case: GC, Case T-27/10, *AC Treuhand v Commission*, ECLI:EU:T:2014:59; CJEU, Case C-194/14 P, *AC Treuhand v Commission*, ECLI:EU:C:2015:717.

infringements in the UK<sup>20</sup>. All those cases show that an undertaking in the position of (B) must give attention to ensure that it does not act as the intermediary of a horizontal agreement between (A) and (C) (See Whish & Bailey, 2012, p. 339).

When approaching the subject in the context of Turkish law, it has been shown that there are limited numbers of decisions where the Board assessed whether there were hub and spoke collusions. Especially two of these resolutions have importance. In the *Lastik Decision*, which is the first decision discussing the existence and conditions of a hub and spoke, the criteria applied in English court practice were referred to<sup>21</sup>. In this case, which became the subject of the *Lastik Decision*, it was determined that three main provider undertakings, showing activity in the tyre sector, shared the future tyre purchase prices through common dealers and that the providers determined the prices, depending on the information coming from competitors. However, it has been concluded that “it does not restrict the competition in terms of purpose” on grounds that dealers, acting as intermediary for indirect information exchange, act with the purpose of having providers lower the purchase price<sup>22</sup>. It was alleged that the content of the decision showed that the Board did not adopt a *per se* approach in hub and spoke collusions and adhered to the *rule of reason* analysis (Doğan, 2017, p. 414). It might be speculative to conclude that in the *Lastik (Tyre) Decision*, the Board adopted the *rule of reason* approach. It might not be consistent to make the *rule of reason* analysis, based on the criterion in English case law, where hub and spoke are *per se* violated. This criterion does not consider effect but rather the object factor (Gürkaynak, İnkiler & Şen, 2013). The Board, at the end of its evaluation, concluded that that the above-mentioned criterion did not exist<sup>23</sup>.

The Board, through its *Oyun (Game) Decision*, which is the second decision of the Board on the hub and spoke structure, concluded that there was no hub and spoke collusion among the market players<sup>24</sup>. The interesting part of this decision is that the Board found distinct anticompetitive agreements among the supplier and some of the

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<sup>20</sup> UK OFT, 10 April 2010, CA98/01/2010 and UK CAT, *Imperial Tobacco Group and Imperial Tobacco v OFT et al.*, [2011] CAT 41, Case 1160/1/1/10, 1161/1/1/10 and ff (*Tobacco*); UK OFT, 26 July 2011, CA98/03/2011 and UK CAT, *Tesco Stores, Tesco Holdings, Tesco PLC v OFT*, [2012] CAT 31, Case 1181/1/1/11 (*Diary*). See for more information and detailed analysis of these cases Odudu, 2011; Gürkaynak, İnkiler & Şen, 2013.

<sup>21</sup> Turkish Competition Board, 16.12.2015, Decision No: 15-44/731-266, para. 38.

<sup>22</sup> Turkish Competition Board, 16.12.2015, Decision No: 15-44/731-266, para. 50.

<sup>23</sup> Turkish Competition Board, 16.12.2015, Decision No: 15-44/731-266, para. 36-50.

<sup>24</sup> Turkish Competition Board, 07.11.2016, Decision No: 16-37/628-279, para. 538, 851.

retailers. However, in the *Oyun Decision*, the condition of rim/horizontal agreement between spokes was not proven<sup>25</sup>.

## 5. ANALYSING HUB AND SPOKE COLLUSIONS

The qualification of a hub and spoke as a type of indirect information exchange and especially when such indirect information exchange will be considered as an anticompetitive agreement or a concerted practice are not straightforward (Jones & Sufrin, 2016, p. 161). According to the court practice explained under the previous sections, hub and spoke collusions may be deemed as *per se* illegal agreements under certain conditions. This agreement may have characteristics of a triangle agreement.

On the other hand, in economic literature notable objections have been raised against the approach of *per se* prohibition of hub and spoke collusions. These objections can be summarized under four main points:

First of all, the hub and spoke concept, by its nature, contains horizontal and vertical elements. In economic literature, vertical relations are generally accepted as those that contribute to economic efficiency (Van Cayseele, 2014, p. 168; Zampa & Buccirosi, 2013, p. 93). Consequently, it has been argued that the analysis of whether hub and spoke collusions are anti-competitive should be subject to the rule of reason analysis (Van Cayseele, 2014, p. 168).

Secondly, one of the tools used in describing a hub and spoke as a cartel or concerted practice<sup>26</sup> is intent (knowledge) which is inspired by criminal law while other tool is facilitation. The common supplier is a vertical participant, having different incentives and when this characteristic of common supplier is considered, it may not be adopted, as a rule, that it has the “intention” to enter into a horizontal agreement (Falls & Saravia, 2015, p. 9-10).

Thirdly, another analytical tool, used in the assessment of hub and spoke is the analysis of “independent vs. coordinated conduct”. This analytical tool has been borrowed from the analysis of *per se* prohibited horizontal agreements. The tool, used in the

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<sup>25</sup> Turkish Competition Board, 07.11.2016, Decision No: 16-37/628-279, para. 234, 337, 238, 326.

<sup>26</sup> In the author’s view, as Zampa & Buccirosi, claims that absent a clear-cut, cartel-like scenario, the triangular dynamics inherent in hub and spoke collusions should be assessed under TFEU Art. 101 or TAPC Art. 4 through the criteria of concerted practice and not of an agreement (Zampa & Buccirosi, 2013, p. 99-101, p. 108; see also Lubambo, 2015, p. 144-145, 160-161).

horizontal element, might not be beneficial enough for the description of vertical relations (Falls & Saravia, 2015, p. 9-10). Likewise, it can be argued that in case a competitor discloses sensitive information (e.g. intended retail prices) directly to another competitor and this is admitted, even if agreement or concerted practice can be accepted, it's not easy to draw the same conclusion in vertical relations where a valid commercial relation exists<sup>27</sup> (Jones & Sufrin, 2016, p. 161).

This last objection was brought to the UK Court of Appeal as a defence. However, the Court of Appeal rejected this defence with the following reason: Not the pure vertical communication among the supplier and retailers but the communication between undertakings in vertical relation<sup>28</sup>, which have horizontal elements, are problematic for competition law<sup>29</sup> (See Lianos, 2008, p. 1059).

Fourthly and finally, indirect information exchange is not specific to the hub and spoke concept. In other words, it's not easy to establish or continue a cartel only through indirect information exchange. Therefore, it might be important to investigate other motives and factors accompanying indirect information exchange<sup>30</sup>. As hub and spoke collusions are not monolithic, there is a need to move from a formalistic approach to an approach of studying economic incentives driving suppliers and retailers to reach horizontal collusions. Understanding the incentives of the participants of alleged hub and spoke collusions can help competition authorities and courts to identify hub and spoke collusions, and assess the liability of participants precisely (Amore, 2016; Falls & Saravia 2015; Zampa & Buccirosi, 2013).

Consequently, especially under Turkish law, a cartel is defined in a manner covering the concepts of agreement and concerted practice. It can be said that describing hub and spoke as an agreement or concerted practice in legal terms will not be important practically, in principle. Differently from cartel arrangement, hub and spoke may lead to economic efficiency. In our estimation, hub and spoke could increase economically both consumer welfare and social welfare under certain conditions, and thus

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<sup>27</sup> There can be legitimate repeated interaction between economic players in vertical relationship (Zampa & Buccirosi, 2013, p. 93-95, p. 139).

<sup>28</sup> For example, the discussions between supplier and dealer about matters such as whole sale prices, profit margins, likely retail prices would not be problematic, provided that they are of a pure vertical nature (Whish & Bailey, 2012, p. 339).

<sup>29</sup> England and Wales Court of Appeal, *Argos and Littlewood v. OFT and JJB Sports v OFT*, [2006] EWCA Civ 1318, Cases 2005/1071, 1074 and 1623, para. 106.

<sup>30</sup> For instance, recommended price maintenance ("RPM") clauses, exclusivities, and most favoured nation ("MFN") clauses can play an important role in hub and spoke collusions: For detailed information see Amore, 2016, p. 33 ff.; Lubambo, 2015, p. 147-158.

considering hub and spoke collusions as *per se* illegal may not be the best approach. Therefore, it is of significant importance to distinguish, at least, a hub and spoke structuring that might constitute *per se* infringements from the others. It can be concluded that if a hub and spoke collusion is described as a breach of competition law, it might lead to tort liability for compensation, together with the administrative sanction imposed on relevant undertakings.

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## **CRIMES OF UNFAIR COMPETITION COMMITTED BY AFFECTING THE CONTROL OF ACTIONS OF EMPLOYEES, AGENTS OR OTHER ANCILLARIES OF ANOTHER PERSON IN THE TURKISH COMMERCIAL CODE NO. 6102**

**Dr. Mehmet Maden\* §**

### **SUMMARY**

*Three alternative acts of the crime of unfair competition under the Turkish Commercial Code No. 6102 will be explored in this paper: “Seeking to obtain advantage for one’s self or for someone else by affording or offering to employees, agents or other ancillaries of a third party benefits to which they are not legally entitled and which are adequate to induce those persons to act contrary to their duty in accomplishing their work”; “inducing workers, agents or other ancillaries to disclose or pry into the manufacturing and work secrets of their employer or principal” and “deceiving employees, agents or other ancillaries in order to make them pry into the manufacturing or trading secrets of their employer or principal”.<sup>1</sup>*

*After a general explanation, protected legal value, elements of the crime, culpability and the special appearances of the crime (attempt, complicity and multiplicity of crimes) will be explored and information on the sanctions and investigation and prosecution phases of the crime will be given.*

**Key Words:** *Turkish unfair competition law; Turkish criminal law; crime of unfair competition; manufacturing secrets; work secrets; inducing; deceiving; affecting control of actions.*

### **INTRODUCTION AND CONTEXT**

Under the Article 62 of the Turkish Commercial Code (TCC), crimes of unfair competition are regulated in four groups and the acts of crime of unfair competition are regulated as alternative acts (see: Güneş, p. 353). The Article 62 of the TCC on

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<sup>1</sup> Translations of these three regulations are mainly taken from the World Intellectual Property Organization’s (WIPO) site (January 23, 2017) (translation of Swiss Federal Law on Unfair Competition): [http://www.wipo.int/wipolex/en/text.jsp?file\\_id=125647](http://www.wipo.int/wipolex/en/text.jsp?file_id=125647).

criminal provisions provides three acts beside its reference to the acts regulated in Article 55.

The above-mentioned four groups are determined as below:

- a) Intentionally committing an act of unfair competition regulated in Article 55,
- b) For their offers and tenders to be preferred to the competitors', to give intentionally incorrect or misleading information in respect of their personal situation, goods, work goods, business and works,
- c) Deceiving employees, agents or other ancillaries in order to make them pry into the manufacturing or trading secrets of their employer or principal,
- d) As an employer or principal, not to prevent the act of the workers, employees or agents in case of learning of their committing a punitive unfair competition act in the course of their works or not to correct the incorrect statements.

According to Article 62 (TCC), crime of unfair competition under TCC is among the crimes prosecuted in case of complaint. A complaint may be lodged by anyone entitled to institute civil proceedings under Article 56 (TCC). Sanction of the crime is imprisonment or a judicial fine of up to two years.

As stated in the title of the paper, a common feature of all three alternative acts of the crime of unfair competition explored in this study is their commission by **affecting the control of actions** of employees, agents or other ancillaries of other people.

These acts are regulated under Articles (by reference to Article 62 (1)-a) 55 (1)-b-2 and 55 (1)-b-3 and under Article 62 (1)-c. These alternative acts of the crime of unfair competition are "seeking to obtain advantage for one's self or for someone else by affording or offering to employees, agents or other ancillaries of a third party benefits to which they are not legally entitled and which are adequate to induce those persons to act contrary to their duty in accomplishing their work"; "inducing workers, agents or other ancillaries to disclose or pry into the manufacturing and work secrets of their employer or principal" and "deceiving employees, agents or other ancillaries in order to make them pry into the manufacturing or trading secrets of their employer or principal".<sup>2</sup>

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<sup>2</sup> Translations of these three regulations are mainly taken from the World Intellectual Property Organization's (WIPO) site (January 23, 2017) (translation of Swiss Federal Law on Unfair Competition): [http://www.wipo.int/wipolex/en/text.jsp?file\\_id=125647](http://www.wipo.int/wipolex/en/text.jsp?file_id=125647).

This paper will try to present an overview of the above-mentioned alternative acts of the crime of unfair competition. After a general explanation, protected legal value, elements of the crime, culpability and special appearances of the crime (attempt, complicity and multiplicity of crimes) will be explored, and information on the sanctions, investigation and prosecution phases of the crime will be given.

## **1. PROTECTED LEGAL VALUE**

Article 54 of the TCC is a good reference in determining the general protected legal value of the crime of unfair competition. According to Article 54 (1) of the TCC, the purpose of the regulations of TCC in the Part on Unfair Competition is “ensuring fair and undistorted competition in the interest of all concerned”.

It is stated that the general protected legal value is the provision of order of fair competition and the protection of public order in the market (Güneş, p. 350).

Erdoğan accepts that the main value protected by the crime of unfair competition under the Article 62 of the TCC is the competition in the commercial environment. As a result, he concludes that it should be accepted that primarily the economic order and the assets and subsequently moral values like commercial reputation are protected. (Erdoğan, p. 433).

In respect of the alternative acts in hand, there are also specific protected legal values beside the general protected legal value. Specifically protected legal value for the first alternative act is the protection of obligations emanating from contracts; thereby the legal certainty. Specifically protected legal value for the second alternative act is the protection of manufacturing and work secrets. Specifically protected legal value for the third alternative act is the protection of manufacturing and trading secrets.

## **2. MATERIAL ELEMENTS**

### **2.1. Subject of Crime**

The subject of the crime of unfair competition is the “fair and undistorted competition”.

## 2.2. Act

In the case of the articles 62 and 55 of the TCC taken together, it can be seen that the crime of unfair competition under the TCC is a crime which can be committed by alternative acts (Erdoğan, p. 433). As a result, if the acts regulated in Articles 62 or 55 are committed at the same time, it will constitute just one crime but it may affect the determination of the sentence according to the Article 61 of the Turkish Criminal Code (Erdoğan, p. 433).

Three alternative acts of the crimes which I classify as “crimes of unfair competition committed by **affecting the control of actions** of employees, agents or other ancillaries of another person” are regulated under the TCC as below:

- 1) Alternative act under the Article 55 (1)-b-2 of the TCC is regulated as; “seeking to obtain advantage for one’s self or for someone else by affording or offering to employees, agents or other ancillaries of a third party benefits to which they are not legally entitled and which are adequate to induce those persons to act contrary to their duty in accomplishing their work”.

In my opinion, the core of this act is “affording or offering benefits” (see also: Nomer Ertan, p. 294). “To obtain advantage for one’s self or for someone else” is the purpose as a mental element of the crime (see also: Nomer Ertan, p. 293). Benefit, afforded or offered, should be adequate to induce employees, agents or other ancillaries of a third party to act contrary to their duty in accomplishing their work (see: Nomer Ertan, p. 294).

For unfair competition in this sense to occur, it is not necessary for the employee, agent or other ancillary to act contrary to their duty; unfair competition occurs even when the employee, agent or other ancillary refuses the offer of benefit (Nomer Ertan, p. 295).

A cleaner, working under a service contract (Turkish Code of Obligations, Articles 393 and 396), members of a board of directors of a joint-stock company and lawyers are all here in the context of “worker, agent and ancillary” (Nomer Ertan, p. 294).

As an example, in the case that an owner of a restaurant gives money to the cook who works in another restaurant, located at the same street, to add too much salt to the dishes in order to make the consumers prefer the owner’s restaurant to the cook’s

restaurant, it will constitute this kind of unfair competition (Teoman (Ülgen et al.), N. 1299).

There is no need for the perpetrator to be a competitor of the victim. On the other hand, there is a condition of suitability in respect of this act. There is no need for the perpetrator to obtain advantage for one's self or for someone else, suitability of the act to obtain advantage is enough for the unfair competition to occur (Teoman (Ülgen et al.), N. 1300). As another example, let us take the case of anyone who is not an owner of a restaurant and who induces the waiters to act contrary to their duty in performing their work, it will not by itself constitute this act (Teoman (Ülgen et al.), N. 1300).

- 2) Alternative act under the Article 55 (1)-b-3 of the TCC is regulated as; "inducing workers, agents or other ancillaries to disclose or pry into the manufacturing and work secrets of their employer or principal".

Dictionary meaning of "induce" is "to persuade someone to do something" (Cambridge Dictionary Online <https://dictionary.cambridge.org/dictionary/english/induce> (October 25, 2017).

Inducing can be related to the manufacturing or work secrets, whether known or unknown to the ancillary; inducing to pry into one's secrets can be done when the secrets are unknown to the ancillary (Nomer Ertan, p. 300).

Mentioned secrets for the second (Art. 55 (1)-b-3) and third (Art. 62 (1)-c) alternative acts are not all secrets but "manufacturing or work/trading" secrets; private "personal" secrets are not under protection in this context (Nomer Ertan, p. 298).

Worker, agent or other ancillary should be under the obligation of confidentiality (e.g. Turkish Code of Obligations, Article 396/III) (Nomer Ertan, p. 299).

- 3) Alternative act under the Article 62 (1)-c of the TCC is regulated as "deceiving employees, agents or other ancillaries in order to make them pry into the manufacturing or trading secrets of their employer or principal".

Because of the reference made in Art. 62 (1)-a to all unfair competition acts regulated in Art. 55, it is argued that there is no need for the regulation in Art. 62 (1)-c (Kendigelen, pp. 85-86).

Prying into the manufacturing or trading secrets is not a condition for the completion of the crime (see: Aydın, p. 186). "Discovery (by employees, agents or other ancillaries of another person) of the manufacturing or trading secrets (of their employer or principal)" is the purpose of the act as a mental element and it will be taken in hand below, under the title of "mental elements".

Dictionary meaning of "deceive" is "to persuade someone that something false is the truth, or to keep the truth hidden from someone for your own advantage" (Cambridge Dictionary Online <https://dictionary.cambridge.org/dictionary/english/deceive> (October 25, 2017)) or "to make someone believe something that is not true" (Cambridge Dictionary Online <https://dictionary.cambridge.org/dictionary/turkish/deceive> (October 25, 2017))

Deceiving could be perpetrated through obtaining advantage of the lack of information or the lack of experience of relevant people or by affording or offering them benefits (Teoman (Ülgen et al.), N. 1300); see also: Aydın, p. 186).

For this act, a deceived person should be considered to be an "employee", "agent" or "other ancillary".

### **2.3. Outcome**

For the first alternative act there is no need for an element of outcome for the crime to be completed. In other words, crime is completed by the completion of the act. As an example, the perpetrator's gaining benefit is not necessary for the completion of the crime (Aydın, p. 58).

On the other hand, for the second alternative act, it can be stated that the "inducement" of the ancillary is an outcome as an element of the crime.

Similarly, for the third alternative act, it can be stated that the ancillary's being deceived is an outcome as an element of the crime.

### **2.4. Perpetrator**

Mentioned crimes are among the crimes which can be perpetrated by anyone; they are not among the "peculiar crimes" (see: Aydın, pp. 57-58; Erdoğan, p. 444; Güneş, p. 348). There is no condition for the perpetrator to be a competitor of the victim or to be a trader (see: Güneş, p. 348). In the theory recognized in the Turkish Criminal Code,

only a natural person (not a legal person) can be a perpetrator of any crime (Turkish Criminal Code, Article 20). But the security measures for the legal persons can be imposed under some conditions. These conditions are examined below, under the title of “sanctions”.

Perpetrator of the first alternative act (TCC, Article 55 (1)-b-2) is the person who “affords or offers benefit”; not the “employee, agent or other ancillaries”. Perpetrator of the second alternative act (TCC, Article 55 (1)-b-3) is the “inducer”; not the “employee, agent or other ancillaries”. Perpetrator of the third alternative act (TCC, Article 62 (1)-c) is the “deceiver”; not the “employee, agent or other ancillaries”.

### **2.5. Victim and Affected Person**

Theoretically, natural/real persons can be victims of a crime; legal persons can only be “affected by the crime” (see: Koca & Üzülmöz, pp. 106-107; Özgenc, p. 210. Compare: Aydın, p. 111; Erdoğan, p. 446). Public legal persons can also be regarded as “affected by the crime”.

General victims of all the three alternative acts explored in this paper are accepted as “all the individuals in the society”. Besides, there are specific victims of these acts. In all cases, victim is a third party (employer or principal); not the worker, employee, agent or the other ancillaries.

Also, it is important that there is no condition for the victim to be a competitor of the perpetrator or to be an autonomous trader.

According to Article 62 of the TCC, crime of unfair competition under the Code is among the crimes prosecuted in case of complaint. A complaint may be lodged by anyone entitled to institute civil proceedings under Article 56. These groups will be listed below under the title of “investigation and prosecution”.

### **3. MENTAL ELEMENTS**

There are two mental elements of the alternative acts of unfair competition crime explored in this paper: intent and purpose.



Purpose of the first alternative act (Article 55 (1)-b-2) is “to induce employees, agents or other ancillaries to act contrary to their duty in accomplishing their work”; thereby “to obtain advantage for one’s self or for someone else”. As a result, for example, if the perpetrator affords ancillaries of a third party benefits to which they are not legally entitled to, in order to induce them to act contrary to their duty in accomplishing their work but for just prejudicing a third party, without seeking to obtain advantage for one’s self or for someone else, it will not constitute the crime.

Purpose of the second alternative act (Article 55(1)-b-3) is the “disclosure or discovery (by workers, agents or other ancillaries of another person) of the manufacturing or work secrets (of their employer or principal)”.

Purpose of the third alternative act (Article 62 (1)-c) is the “discovery (by employees, agents or other ancillaries of another person) of the manufacturing or trading secrets (of their employer or principal)”.

#### **4. ELEMENT OF ILLEGALITY**

Element of illegality does not have a special feature in the alternative acts explored in this paper (see: Aydın, p. 89). Especially, consent as a reason for justification can be relevant for these alternative acts (see: Aydın, pp. 93-94; Erdoğan, pp. 449-450).

#### **5. CULPABILITY**

General rules of culpability apply to the alternative acts explored in this paper.

#### **6. SPECIAL APPEARANCES OF THE CRIME**

##### **6.1. Attempt**

It can be stated that the first act explored in this paper is among the “mere act crimes”; crime will be completed by the commission of the act; there is no need for an outcome for the crime to be completed (Aydın, p. 102). As an example, gaining benefit of the perpetrator is not necessary for the completion of the crime (Aydın, p. 58).

On the other hand, for the second alternative act, it can be stated that the “inducement” of the ancillary is an outcome as an element of the crime (compare: Aydın, p. 102). Similarly, for the third alternative act, it can be stated that the “situation of being deceived” of the ancillary is an outcome as an element of the crime (compare: Aydın, p. 102).

Accordingly, for the second and third alternative acts explored in this paper, if the perpetrator completes all the acts for the commission of the crime of unfair competition they intended to commit, but where, due to reasons beyond their control, the outcome does not take place, they shall be punished for attempt to the crime of unfair competition (see: Gölcüklü, p. 166).

The mental element of these crimes is intent; commission of the crimes with negligence is not regulated; hence attempt to these crimes is possible in principle (see: Aydın, p. 102).

## **6.2. Complicity**

General rules of complicity are valid for the crimes of unfair competition explored in this paper.

## **6.3. Multiplicity of Crimes**

General rules of multiplicity of crimes (Turkish Criminal Code, Articles 42-44) apply to the alternative acts explored in this paper.

## **7. SANCTIONS**

Sanction of the crime of unfair competition is determined as an imprisonment or a judicial fine of up to two years (TCC, Article 62). The sanction was determined in the repealed Turkish Commercial Code Art. 64 as imprisonment from one month up to one year or/and a heavy fine of five hundred Turkish Liras up to ten thousand Turkish Liras.

Under the TCC, punishment for the crime of unfair competition has increased when compared to the repealed Turkish Commercial Code.

According to Turkish Criminal Procedure Code, Art. 231 (5), in cases where the punishment, at the end of adjudication, is maximum two years of imprisonment or a judicial fine, pronouncement of the judgement may be delayed.

In the case that the punishment, at the end of adjudication, is maximum two years of imprisonment (not a fine), it may be suspended; the maximum length of imprisonment in this context is three years for people who are under the age of 18 at the date of the act conducted and for people who are older than 65 (Turkish Criminal Code, Art. 51).

In the case that the punishment, at the end of adjudication, is maximum one year of imprisonment, it may be commuted to alternative sanctions (Turkish Criminal Code, Art. 49 (2) and Art. 50); notwithstanding the criteria applied to other people, imprisonment of maximum one year shall be commuted to alternative sanctions for people who are under the age of 18 at the date of the act conducted and for people who are older than 65, providing that they have not been convicted to imprisonment before (Turkish Criminal Code, Art. 50 (3)).

Because of the fact that crimes of unfair competition may only be committed by intent, as a legal consequence of the sentence of imprisonment, perpetrator may be disqualified from the use of some rights during the execution period of the imprisonment (Turkish Criminal Code, Art. 53).

Imprisonment and judicial fine are alternatives as the sanctions for the crime of unfair competition. In Turkey's criminal law, a day fine system is accepted. Accordingly, the total amount of the fine is calculated by the multiplication of two numbers, namely the amount of the day and the daily amount determined for the perpetrator (Turkish Criminal Code, Art. 52 (1)). The daily amount is determined by considering the economic and other personal conditions of the perpetrator (Turkish Criminal Code, Art. 52 (2)).

According to the Article 63 of the TCC on the criminal law responsibility of legal persons; in the case that unfair competition is committed in the course of the activities of a legal person, the security measures for the legal persons may also be determined.

Two security measures, namely the cancellation of licence and the confiscation, are regulated under the Article 60 of the Turkish Criminal Code on the security measures for the legal persons. According to the Article 60 of the Turkish Criminal Code; cancellation of licence as a security measure for the legal persons can be determined

under these conditions: Firstly, there should be a private law legal person operating under the licence granted by a public institution. Secondly, a conviction for a crime committed by intent through the participation of the authorities or representatives of the above-mentioned legal person should exist. Thirdly, the above-mentioned crime should be committed for the benefit of the legal person. Fourthly, this crime should be committed by the misuse of the authorisation conferred by the above-mentioned licence.<sup>3</sup>

Provisions of confiscation shall be applied to the private law legal persons in the case that a crime is committed for their benefit (Turkish Criminal Code, Art. 60 (2)).

The court may not impose these measures on the legal persons, considering the principle of proportionality (Turkish Criminal Code, Art. 60 (3)).

## **8. INVESTIGATION AND PROSECUTION**

As stated under the title of “victim and affected person”, according to the Article 62 of the TCC, a crime of unfair competition under the TCC is among the crimes prosecuted in case of complaint. A complaint may be lodged by anyone entitled to institute civil proceedings under Article 56. According to Article 56, these persons are;

(1) Whoever, through an act of unfair competition, suffers or is likely to suffer prejudice to their clientele, credit, professional reputation, business or other economic interests<sup>4</sup>;

(2) Customers who suffer or are likely to suffer prejudice to their economic interests;

(3) Chambers of commerce and industry, chambers of tradespeople, stock exchanges, and other professional and economic associations who are authorized by their statutes to protect the economic interests of their members; nongovernmental organisations

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<sup>3</sup> See the translation (partly false and partly lacking) on <http://www.wipo.int/edocs/lexdocs/laws/en/tr/tr171en.pdf> .

<sup>4</sup> Translation is mainly taken from the World Intellectual Property Organization’s (WIPO) site (October 31, 2017) (translation of Swiss Federal Law on Unfair Competition): [http://www.wipo.int/wipolex/en/text.jsp?file\\_id=125647](http://www.wipo.int/wipolex/en/text.jsp?file_id=125647).

and institutions of public nature who protect the economic interests of consumers according to their statutes.

## 9. CONCLUSION

By generally examining the crime of unfair competition and particularly the three alternative acts of this crime, we can conclude that the subject of the crime of unfair competition is the “fair and undistorted competition”. It is seen that the crime of unfair competition is a crime which can be committed by alternative acts. As a result, if the acts regulated in the Articles 62 or 55 of the Turkish Commercial Code (TCC) are committed at the same time, it will constitute just one crime but it may affect the determination of the sentence according to the Article 61 of the Turkish Criminal Code.

It can be stated that the core of the first alternative act explored in this paper (TCC, Art. 55 (1)-b-2) is “affording or offering benefits”; “to obtain advantage for one’s self or for someone else” is the purpose, as a mental element of the crime. Benefit, afforded or offered, should be adequate to induce employees, agents or other ancillaries of a third party to act contrary to their duty in accomplishing their work. It is not necessary for the employee, agent or other ancillary to act contrary to their duty; unfair competition occurs even when the employee, agent or other ancillary refuses the offer of benefit. There is no condition for the perpetrator to be a competitor of the victim but there is a condition of suitability in respect of this act. To obtain advantage for one’s self or for someone else is not necessary; suitability of the act to obtain advantage is enough for the unfair competition to occur.

The secrets under protection for the second (TCC, Art. 55 (1)-b-3) and third (TCC, Art. 62 (1)-c) alternative acts are not all secrets (e.g. private personal secrets) but the “manufacturing or work/trading” secrets.

For the third alternative act (TCC, Article 62 (1)-c), prying into the manufacturing or trading secrets is not a condition for the completion of the crime. “Discovery (by employees, agents or other ancillaries of another person) of the manufacturing or trading secrets (of their employer or principal)” is the purpose of the act as a mental element.

In the case of the first alternative act, for the crime to be completed there is no need for an element of outcome. On the other hand, for the second alternative act it can be stated that the “inducement” of the ancillary is an outcome. For the third alternative act, it can be stated that the “situation of being deceived” of the ancillary is an outcome as an element of the crime.

Unfair competition crimes involving the above-mentioned alternative acts can be perpetrated by anyone; they are not among the “peculiar crimes”.

There are specific victims of all the three alternative acts explored in this paper beside the general victim (namely “all the individuals in the society”). In all these cases, victim is a third party (employer or principal); not the worker, employee, agent or the other ancillaries. There is no condition for the victim to be a competitor of the perpetrator or to be an autonomous trader.

Intent and purpose are the mental elements of the above-mentioned alternative acts.

Pronouncement of the judgement may be delayed and also the punishments of imprisonment may be suspended in the related cases. Punishments of imprisonment may be commuted to alternative sanctions in some cases. In some cases, perpetrator may be disqualified from the use of some rights during the execution period of imprisonment. In the case that unfair competition is committed in the course of the activities of a legal person, security measures for the legal persons may also be determined.

Crime of unfair competition under the TCC is among the crimes prosecuted in case of complaint. A complaint may be lodged by anyone entitled to institute civil proceedings under the Article 56 of the TCC.

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## MERGER CONTROL IN TURKISH COMPETITION LAW

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### 1. PREAMBLE

In Turkey, the audit or in accordance with competition law terminology, control system of mergers and acquisitions is based on a single article in the Turkish Act on the Protection of Competition 4054 (*“Competition Act”* or *“TAPC”*). Article (*“Art.”*) 7 is as follows:

*“Merger by one or more undertakings, or acquisition by any undertaking or person from another undertaking – except by way of inheritance – of its assets or all or a part of its partnership shares, or of means which confer thereon the power to hold a managerial right, with a view to creating a dominant position or strengthening its/their dominant position, which would result in significant lessening of competition in a market for goods or services within the whole or a part of the country, is illegal and prohibited.*

*The Board shall declare, via communiqués to be issued by it, the types of mergers and acquisitions which have to be notified to the Board and for which permission has to be obtained, in order for them to become legally valid.”*

The above-mentioned rule is the third and last restrictive provision set out in the Competition Act following Art. 4 (*“Agreements, Concerted Practices and Decisions Restricting Competition”*) and Art. 6 (*“Abuse by Undertakings of their Dominant Positions”*). Such provisions restrict collusive relations that impede the competition.

As understood from its definition, Art. 7 of the Competition Act is different from the other prohibitive articles thereof in the sense that it is meant to directly control market structure rather than anti-competitive practices. In light of this, it can be assessed as a precautionary measure (*“ex-ante provision”*). The ultimate aim here is to prevent market concentration in terms of permanent structural operations. For this reason, undertakings have to give a pre-transaction notice to the Competition Board (*“Board”*),

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which then analyses whether post-transaction concentration will be enhanced in a way that negatively affects market performance<sup>1</sup>.

The second paragraph of Art. 7 prescribes that not every single transaction needs to be notified unless the relevant transaction exceeds a specific threshold (which shall be set by means of a Communiqué that the Board might issue). The Board has expressly laid down and defined these conditions in Communiqué No. 2010/4 on Mergers and Acquisitions Subject to Permission from the Competition Authority ("*Communiqué 2010/4*") and has introduced certain specific and conceptual regulations on concentration, analysis of unlawfulness and measures.

Art. 7 of the Competition Act and the applicable secondary legislation may be categorized under *three headings*. *The first concept* refers to what the technical meaning of merger and acquisition is. *The second concept* deals with which transactions (as a merger or an acquisition) should be notified. Finally, *the third concept* explains how the Board will evaluate such transactions (and in what way), conditions prohibiting those transactions (Communiqué 2010/4, Art. 13) and albeit in an unelaborated way, the commitment mechanism (Communiqué 2010/4, Art. 14).

## **2. CONCEPTS OF MERGER AND ACQUISITION AND, IN PARTICULAR, THE SIGNIFICANCE OF "CONTROL"**

In competition law, mergers and acquisitions referred to in the Competition Act are interpreted in a way that is profoundly divergent from the interpretation of the rest of legislation, especially the Turkish Code of Commerce No. 6102 ("*TCC*"). The important point here is that the procedures shall govern the merger or acquisition as well as said transactions' legal consequences, in particular, for creditors, debtors and shareholders. Such processes and consequences are regulated in the codes in detail.

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<sup>1</sup> For further information about Turkish competition law see İ. Yılmaz Aslan, *Rekabet Hukuku: Teori-Uygulama-Mevzuat, Güncellenmiş ve Genişletilmiş 5. Baskı*, Bursa 2017, p. 789 ff.; Ercüment Erdem, *Türk ve AT Rekabet Hukukunda Birleşme ve Devralmalar*, İstanbul 2003, p. 29 ff.; Ercüment Erdem, *Türk-İsviçre Rekabet Hukuklarında Birleşme ve Devralmalar, Rekabet Hukuku ile İlgili Makaleler*, İstanbul 2007, p. 1-37; Pelin Güven, *Türk Rekabet Hukuku ve Avrupa Birliği Rekabet Hukukunda Birleşme ve Devralmaların Denetlenmesi, Genişletilmiş 2. Baskı*, Ankara 2003, p. 103 ff.; Pelin Güven, *Rekabet Hukuku, Genişletilmiş 2. Baskı*, Ankara 2008, p. 363 ff.; Kerem Cem Sanlı, *Rekabetin Korunması Hakkında Kanun'da Öngörülen Yasaklayıcı Hükümler ve Bu Hükümlere Aykırı Sözleşme ve Teşebbüs Birliği Kararlarının Geçersizliği*, Ankara 2000, p. 314 ff.; Helin Berfin Akyüz, *Türk Rekabet Hukuku Kapsamında Şirketlerde Birleşme ve Devralmalar*, Ankara 2007, p. 69 ff.

It must be noted that the concepts of mergers and acquisitions are mainly built on economic grounds under the competition law regime. Thus, in the terminology and practice of competition law, the concept of merger also includes the acquisition. Yet, under competition law regulations, a merger is distinct from an acquisition - at least with respect to legal conception. However, this does not affect the economic approach of competitiveness, since the focal point is not the realization process but changing control of an undertaking.

In plain words, the legal procedure followed in a merger or acquisition does not play a role. The decisive factor is whether “*lasting change*” occurs in the post-transaction control structure of undertakings that were independent prior to the transactions. Pursuant to this concept, *in principle*, both the transfer of minority shares and the intra-group transaction may not be considered as an acquisition.

The *basic objective* of Art. 7 of the TAPC is to control market concentration, which means a control over the decrease in the number of undertakings or transfers of asset and property as between undertakings<sup>2</sup>. In this respect, it would be of vital importance to know if the transaction led to a drop in the number of players engaged in business operations in the market or assets that allow these operations to change hands permanently as between undertakings. Unless such a shift in a number of controllers occurs, the transaction may not be qualified as a merger or acquisition in the sense set out in Art. 7 of the TAPC<sup>3</sup>.

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<sup>2</sup> For extensive evaluation of the European Union (“EU”) competition law also see Alison Jones/Sufrin Brenda, *EC Competition Law*, 3rd Edition, Hampshire 2007, p. 941 ff.; Richard Whish, *Competition Law*, 6th Edition, Hampshire 2009, p. 798 ff.; Ivo Van Bael/Jean-François Bellis, *Competition Law of the European Community*, 5th Edition, Netherlands 2010, p. 633 ff.; Sandra Marco Colino, *Competition Law of the EU and UK*, 7th Edition, Hampshire 2011, p. 348 ff.; comparison with United States of America (“US”) competition law also see Phillip Areeda/Louis Kaplow, *Antitrust Analysis: Problems, Text and Cases*, 5th Edition, New York 1997, p. 785 ff.; Herbert Hovenkamp, *Federal Antitrust Policy: The Law of Competition and Its Practice*, 2nd Edition, St. Paul 1999, p. 490 ff.

<sup>3</sup> It should be noted that a merger or an acquisition covered by company law mostly leads to this type of concentration. However, this is not strictly necessary by its nature. To clarify things, a classic example is surely in order: Suppose that there are two daughter companies (subsidiaries) called (B) Inc and (C) LLC controlled by (A) Holding Inc. (A) thinks that a merger of (B) and (C) would be very wise with regards to its investment policy. In case these two companies merge, and a company called (BC) appears, or (B) acquires (C), this will still operate as a merger under the company law. Considering this fact, a merger is carried out as per the provisions of TCC and its implications will be subject to the same. Notwithstanding the foregoing, there is no merger or acquisition here in the sense of the competition law since neither (B) nor (C) has been an independent business concern from the very beginning. Here, from the perspective of the competition law, (A) Holding Inc. is called as the undertaking that also includes (B) and (C). One cannot argue that there will be a lasting change in the post-transaction

*Another key point* is that legal substance or the nature of the transaction is not the determinative factor for Art. 7 of the TAPC. This means that the transaction that paves the way for the concentration may be an assignment like a share transfer or may even be a lease, license or service contract. However, since the franchisee acquires rights and bears obligations on its own account, franchise agreements would not result in an alteration of control<sup>4</sup>. When considering a change in control on a lasting basis, these contracts shall be of a long duration and have an impact on the structure of the market<sup>5</sup>. Similarly, other illustrative examples include joint ventures formed as an ordinary partnership [Art. 620 of the Turkish Code of Obligations (“TCO”) *et seq.*] or the execution of a shareholding agreement. Obviously, from the perspective of competition policy, the substantial issue is whether a permanent post-transaction bringing about change in the control of the target undertaking occurs<sup>6</sup>.

Communiqué 2010/4 addresses the concepts of mergers and acquisitions from an economic perspective in parallel with the foregoing. A review of Art. 5/1 of Communiqué 2010/4 shows that mergers and acquisitions are categorized *into two different* subparagraphs, respectively.

*Cases Considered as a Merger or an Acquisition*

*ARTICLE 5 – “(1) Under Article 7 of the Act,*

*(a) The merger of two or more undertakings, or*

*(b) The acquisition of direct or indirect control over all or part of one or more undertakings by one or more undertakings or by one or more persons who currently control at least one undertaking, through the purchase of shares or assets, through a contract or through any other means shall be considered a merger or acquisition transaction, provided there is a permanent change in control.”*

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controlling structure. Then it is evident that there will be no acquisition or concentration in the sense set out in Art. 7 of the TAPC and nothing will be notified due to this reason.

<sup>4</sup> Guidelines on Cases Considered as a Merger or an Acquisition and the Concept of Control by Turkish Competition Authority, p. 3.

<sup>5</sup> Guidelines on Cases Considered as a Merger or an Acquisition and the Concept of Control by Turkish Competition Authority, p. 3. In guidelines, the acquisition is deemed when the length of the lease agreement is 5 years in the decision dated 30.10.2008 and numbered 08-61/998-390.

<sup>6</sup> At this point, it may be necessary to note that there is a Communiqué published by the Competition Authority about giving legal effect to acquisitions by means of privatization.

The concept of control set out in Communiqué 2010/4 is described as the “*application of a determinant/decisive effect*” on the undertaking.

*“(2) For the purposes of this Communiqué, control may be acquired through rights, contracts or other instruments which, separately or together, allow de facto or de jure exercise of decisive influence over an undertaking. In particular, these instruments consist of ownership right or operating right over all or part of the assets of an undertaking, and those rights or contracts granting decisive influence over the structure or decisions of the bodies of an undertaking. Control may be acquired by right holders, or by those persons or undertakings who have been empowered to exercise such rights in accordance with a contract, or who, while lacking such rights and powers, have the de facto strength to exercise such rights.”*

If a determinant effect is exerted on an undertaking or a business concern, then it becomes the “*effectively dominant party*” in the designation of its business policies. Means used to achieve that status have no impact on the qualification of control<sup>7</sup>.

Communiqué 2010/4 contains two common types of control: *Individual control* and *joint control*. The control of an undertaking may be taken over by a single undertaking, which would surely lead to individual control, or by two or more undertakings, which would lead to joint control.

*Individual control* means, in its classic sense, a single undertaking’s takeover of control of another undertaking. An undertaking would enjoy sole control by either determining strategic business activities in a firm or using a veto right regarding the

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<sup>7</sup> It is possible to categorise controlling tools from various perspectives under the company law. For instance, in a joint-stock company, the control may be described, in principle, as holding the majority in shareholding. Here the majority means holding shares over 50 per cent of the total amount of shares. As the control depends on the majority of votes in a general meeting, legal instruments that provide for the majority of votes without the necessity to hold a majority shareholding may allow the person using these instruments to enjoy control rights. Here, one can surely refer to a case where the majority of voting rights is held at the general meeting by means of preferential stocks or shareholding or voting contracts. Notwithstanding the foregoing, beneficial ownership over stocks based on representation relation, and accordingly, a right to nominate board members as a direct privilege to shareholders for taking a role in the board of directors without the requirement to have the majority of votes at the shareholder’s meeting may also be described as controlling means. In addition, in the sense of a group of companies, a dominance agreement may be invoked as a legal means with influence over the control of the target company (here cf: Art. 106 of the Trade Registry Regulation). In addition, it would make sense to refer to minority control as well as management control where no block shareholder(s) remains because of a much-dispersed structure in the shareholding of publicly held companies as these stem from a gap in the power which is unique to joint-stock companies. For detailed information on all these control instruments see Ali Pash, *Anonim Ortaklığın Devralınması*, İstanbul 2009, pp. 61-63.

fundamental decision. Sole control can be classified as a *de jure* and *de facto* control. In the former situation, having major voting rights supported by another element may lead to control. Furthermore, a minority shareholder to be granted the right to profoundly affect the business strategy of the company by any means such as preferential stock enjoys sole control. This is especially evident in the latter case where even a minority shareholder has no controlling role. Given the change in voting patterns in past shareholder meetings or economic links of this shareholder, the Competition Authority may see this shareholder as a *de facto* sole controlling shareholder<sup>8</sup>. This classification reflects the economic approach in competition law. The determinant for Competition Authority is whether an undertaking has sole control over another undertaking irrespective of having legal instruments.

A *joint control* may arise when two undertakings exert joint control over an independent undertaking (independent in economic terms) on a permanent basis. There is no doubt that neither undertaking has the sole power to direct the business policies of that undertaking. In this respect, fundamental business policies may not be individually designed by one undertaking without the consent of the other(s)<sup>9</sup>. In other words, unless compromises regarding the business strategy in corporations are reached between undertakings, the controlled company will not make fundamental decisions. To illustrate, having the same voting rights in general board meetings or the right to appoint a member of the board of directors is an indication of joint control if such rights reflect the decisive impact on the business strategy of the controlled company. Additionally, the veto right is a key factor in determining whether joint control of companies occurs or not. Considering veto rights as means of joint control, the scope of this veto right may exceed the substance of the normal veto right granted to minority shareholders for the protection of their financial interest against predatory acts of the majority shareholders<sup>10</sup>. Unless veto rights have a conclusive role in a business strategy, they shall not be deemed tools for acquiring joint control. According to the guidelines<sup>11</sup>, the appointment of senior managers or veto rights related to the investment plan are illustrations of veto rights resulting in joint control. In case undertakings have more than one veto right, such veto rights shall be evaluated

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<sup>8</sup> Guidelines on Cases Considered as a Merger or an Acquisition and the Concept of Control by Turkish Competition Authority, p. 10.

<sup>9</sup> According to the literature, this may be secured by a joint decision-making mechanism or by providing veto rights to one or more than one undertaking.

<sup>10</sup> Guidelines on Cases Considered as a Merger or an Acquisition and the Concept of Control by Turkish Competition Authority, p. 11.

<sup>11</sup> Guidelines on Cases Considered as a Merger or an Acquisition and the Concept of Control by Turkish Competition Authority, p. 12.

holistically<sup>12</sup> - consistent with the economic approach in competition law. In other words, each veto right cannot be individually assessed. The function of all veto rights together shall be reached conclusively if the related undertakings enjoy joint control over the controlled company.

The joint control by multiple undertakings of another undertaking is called the *joint venture* in the competition law literature<sup>13</sup>. In this sense, where a full-function joint venture is formed, or undertakings acquire additional control in the business controlled by another, this is called a joint venture. Communiqué 2010/4 calls the establishment of a joint venture a joint acquisition (Communiqué 2010/4, Art. 5/3).

The transition from joint control to sole control (or vice versa) requires a review, even if it means going back to the former condition since it also includes a change in control<sup>14</sup>. Such change is defined as the change in the quality of control<sup>15</sup>. From an economic viewpoint, a change in the control structure of a company and its effects are the focal points. For instance, after the entries of new shareholders, another undertaking already holding the sole control of the company structure may cooperate with old shareholders in a business strategy opposing the new shareholders. Such cooperation would render the sole control to the existing shareholders. With respect to this change, it could occur even without the intention of the acquirer. The exit of the other shareholders from the joint-stock company may trigger sole control of a shareholder after the exit of the former<sup>16</sup>. A transaction that implicates a change in the joint control is also deemed as a concentration.

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<sup>12</sup> Guidelines on Cases Considered as a Merger or an Acquisition and the Concept of Control by Turkish Competition Authority, p. 12.

<sup>13</sup> While there is no specific definition of a joint venture in either EU or Turkish legislation, both refer to two different types of joint venture only (full-function and partially-function ones). There is a definition solely for a full-function joint venture: "A joint venture that performs all functions of an independent business concern". For information about the full function joint ventures see Önder Suat Uluçlar, *Yoğunlaşmalarda Tam İşlevsellik*, İstanbul 2017, p. 59 ff.

<sup>14</sup> Here one can argue that there is an acquisition as well in case of a transition from single control to joint control or vice versa. This is a common characteristic in acquisitions in the sense set out in the competition law and in acquisitions of joint-stock companies.

<sup>15</sup> Guidelines on Cases Considered as a Merger or an Acquisition and the Concept of Control by Turkish Competition Authority, p. 14.

<sup>16</sup> Guidelines on Cases Considered as a Merger or an Acquisition and the Concept of Control by Turkish Competition Authority, p.4.

### 3. MERGERS AND ACQUISITIONS SUBJECT TO THE NOTIFICATION

As can be seen below, the Board specified a financial threshold. It should also be noted that not all of the said transactions are subject to the Board's review and permission. Thresholds applicable to transactions are defined, as per Art. 7/1 of Communiqué 2010/4:

*“(1) In a merger or acquisition transaction as specified under Article 5 of this Communiqué, authorization of the Board shall be required for the relevant transaction to carry legal validity in case,*

*(a) Total turnovers of the transaction parties in Turkey exceed one hundred million TL, and turnovers of at least two of the transaction parties in Turkey each exceed thirty million TL, or*

*(b) The asset or activity subject to acquisition in acquisition transactions, and at least one of the parties of the transaction in merger transactions have a turnover in Turkey exceeding thirty million TL and the other party of the transactions has a global turnover exceeding five hundred million TL.”*

As one can see, according to the Communiqué, there are *two different* financial thresholds. In case that one of them is exceeded, there is a strict requirement to notify that transaction<sup>17</sup>. Thresholds in the first subparagraph, in fact, concern transactions of active business operations in Turkey. In this respect, both financial thresholds need to be met by the transaction parties. Thresholds in the second subparagraph are concerned with transactions to which undertakings with foreign operations are parties<sup>18</sup>.

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<sup>17</sup> For the purposes of applying Art. 7 of the Communiqué 2010/4, it should be stated that Art. 8 of the Communiqué 2010/4 sets forth a laboriously detailed description about the fact that the aggregate of the turnovers shall be taken as the basis for the purposes of calculating the respective threshold of each transaction party. Considering its importance, it should be noted that two or more transactions as described in Art. 8/2 that take place between the sale persons or parties during a three-year term shall be taken as *one transaction* for calculating thresholds.

<sup>18</sup> It should be noted that this provision of the Communiqué 2010/4 differs from the abolished Communiqué 1997/1. According to the former regulation, a market share threshold was set along with the financial thresholds and it was prescribed that a notification would be strictly required in case both thresholds were exceeded. However, the Communiqué 2010/4 only prescribes a financial threshold system. In face of this fact, there indeed may be certain circumstances whereby a transaction may be notified although it does not enhance a concentration in some way.

#### 4. RESTRICTION CRITERION: “CREATION” OR “REINFORCEMENT” OF A DOMINANT POSITION

The criterion of unlawfulness applied in the evaluation of mergers and acquisitions is a significant impediment to the effective competition by the creation of a dominant position or the reinforcement of an existing one<sup>19</sup>. However, Art. 7 of the TAPC also prescribes that this position should materially impede the competition. In this respect, the prohibition in Art. 7 of the TAPC shall be applicable only if a merger or an acquisition creates a dominant position (either sole or joint) or reinforces an existing one. But this criterion is not solely decisive. Even if it creates a dominant position or reinforces an existing one, an acquisition that would not materially impede the competition in the relevant market shall not be subject to prohibition<sup>20</sup>. Accordingly, it is safe to argue that Art. 7 of the TAPC actually contains a criterion of unlawfulness in a *two-stage* evaluation.

The evaluation to be made under Art. 7 of the TAPC is actually a prospective risk analysis. After the Board determines whether the merger or acquisition exceeds the thresholds stated in Art. 7, it shall be required to examine the transaction with respect to the dominant position.

A case in which the analysis of this criterion does indeed yield a positive result is then investigated, by applying certain criteria, in order to determine whether the competition is significantly impeded by the dominant position. The Board adopts the dominance test as per Art. 7. Yet, under certain circumstances, the Board may flexibly interpret this test and assess the joint dominance as problematic from a competition policy perspective<sup>21</sup>.

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<sup>19</sup> For the assessment on the abuse of a dominant position also see **Gamze Aşçıoğlu Öz**, *Avrupa Topluluğu ve Türk Rekabet Hukukunda Hakim Durumun Kötüye Kullanılması*, Ankara 2000, p. 90 ff.; **Aydın Öztunalı**, *Rekabet Hukukunda Hakim Durumun Kötüye Kullanılması*, Ankara 2014, p. 51 ff.

<sup>20</sup> For instance, while an undertaking enjoying a dominant position acquires a small-scale competitor, this may not significantly lessen the competition although the transaction reinforces its own dominant position (the decision rendered by the Competition Board on 02.05.2000 under no 00-16/160-82). Moreover, please read Art. 13 of the Communiqué 2010/4.

<sup>21</sup> It should be noted here that regarding the analysis of unlawfulness related to Art. 7 of the concerns market analysis, the level of concentration is particularly significant. In this respect, the HHI index is frequently used in transactions with a high-risk factor. The *Herfindahl-Hirschman Index* (abbreviated as HHI) is roughly an index that defines the market concentration as the aggregation of the squares of market shares of all undertakings in the market. Here the important thing is to make use of different criteria based on the vertical or horizontal structure of the acquisitions/mergers. For information about the measurement of concentration levels and the criteria used in this respect, please see the Guideline



## 5. CONSEQUENCES ASSOCIATED WITH UNLAWFUL MERGERS AND ACQUISITIONS

A merger or an acquisition that is subject to notification but is not notified shall first bring about an administrative fine to be paid by the parties (TAPC, Art. 16/1-b)<sup>22</sup>. Indeed, the said regulation prescribes charging a fine equal to one per thousand of the annual gross income of the undertakings. This administrative fine shall be charged on each of the parties in a merger but merely on the acquiring party in an acquisition (Communiqué 2010/4, Art. 10/6). The second sanction of the unlawful act is that the transaction is legally null and void<sup>23</sup> (TAPC, Art. 56; Communiqué 2010/4, Art. 10/4). While it is a matter of hot debate and it is significant on a theoretical level, the third sanction is the fact that an unlawful merger or acquisition will surely trigger a tort liability (TAPC, Art. 57-59)<sup>24</sup>.

## 6. COMMITMENT MECHANISM AND A GENERAL VIEW

Communiqué 2010/4 introduces a mechanism alongside the practices in EU competition law that permits the acquisition transaction - in line with reasonable and effective amendment proposals offered by the parties to overcome and rectify competition problems caused by the transaction. Proposals to mitigate competition problems made in line with this mechanism - known as the *commitment mechanism* -

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for the Evaluation of Horizontal Mergers and Acquisitions No. 15-16 and the Guideline for the Evaluation of Vertical Mergers and Acquisitions No. 25 and others.

<sup>22</sup> Muhammed Safa Uygur, *Rekabet Hukukunda İzinsiz Gerçekleştirilen Birleşme ve Devralmalara Uygulanan Yaptırım Rejimi*, Ankara 2017, p. 32 ff.

<sup>23</sup> Art. 56 of the TAPC does not bring any express regulation as to the results of the private law in connection with mergers and acquisitions in breach of Art. 7. But, considering Art. 7 thereof and other regulations therein, there should be no doubt that legal sanctions applicable to a breach of Art. 7 thereof will surely be a definite nullity (*kesin geçersizlik*). Here the nullity is not merely attributable to the breach of a rule of law but also to a procedural violation (TAPC, Art. 7/2). The Board also introduced certain regulations in this matter by virtue of the Communiqué 2010/4 and the relevant principle was expressly referred to in the Communiqué (Art. 1, 2, 7/1 and 10/4). In this respect, mergers and acquisitions covered by the Communiqué 2010/4 do not become valid until such a time when the Board makes an express or implicit decision. During that time, the transactions are in suspended nullity (*askıda geçersizlik*) phase, as set out similar in Art. 5 of the TAPC. Accordingly, a merger or an acquisition will be definitely null unless it is permitted. For detailed information see Kerem Cem Sanlı, *Rekabetin Korunması Hakkında Kanun'un Özel Hukuk Alanındaki Sonuçları: Genel Bakış ve Sorunlar*, *Rekabetin Korunması Hakkında Kanun'un Özel Hukuk Alanındaki Sonuçları: Sorunlar ve Çözüm Önerileri Sempozyum Kitabı*, İstanbul 2013, p. 19 ff.

<sup>24</sup> For detailed information about all arguments see Buğra Kesici, *Rekabet Hukukunun İhlâlinden Kaynaklanan Haksız Fiil Sorumluluğu*, İstanbul 2017, p. 96 ff.

are examined by the Board and if they are found to be reasonable, the transaction is permitted. In this way, the expected consequences of the concentration are achieved for the said authority and the competition in the market is established (Communiqué 2010/4, Art. 14).

Evidently, as a result of the concentration transaction, the burden of proof to demonstrate such competition problems stemming from Art. 7 of the TAPC is vested with the Board by its very nature. However, before the Board makes its final decision, it may disclose those potential problems and the parties may offer remedies to address potential anti-competitive concerns. What matters here is the fact that the parties are not under any obligation to propose such remedies, which means that making a proposal is left at the discretion of the parties<sup>25</sup>. Similarly, the Board does not have to accept the proposed remedies if it finds such remedies to be inadequate to address the potential anti-competitive concern.

The Turkish Competition Authority defines characteristic features of the conditions acceptable to the Board in the Guideline on Remedies that are Acceptable in Merger/Acquisition Transactions. *First of all*, proposed remedies should be provided with a sound basis in terms of legal and economic principles regarding a specific transaction. An effective remedy should aim to keep the competitive structure of the market intact and to maintain activities arising from the concentration as far as possible.

In other words, if a remedy is proposed and it entails the disposition of a business unit, and this unit constitutes the essence of such concentration, this kind of remedy would be unacceptable. *Secondly*, the basic expectation from the remedy is that it should serve to keep the pre-transaction level of the competition intact. *Thirdly*, the remedy should not protect the competitors but the competition itself. *Finally*, remedy conditions should be clear and applicable.

Remedies proposed to eliminate competition problems caused by the concentration may be, in principle, *i.)* structural or *ii.)* behavioural. In brief, structural remedy proposals are usually based on the disposition of a specific business unit. However,

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<sup>25</sup> It should be noted that the Board is not authorized to force the parties to accept the remedies designed by the Board and the Board may not change the commitments designed by the undertakings. However, in case the Board considers the commitments designed by the undertakings are to be insufficient, there is nothing that prevents it from demanding them to be changed. Here the critical thing is that the Board should feel assured that the commitments by the undertakings will firmly eliminate and dispel away any worries about the competition in connection with the transaction in question so that it can permit such transaction.

behavioural remedy proposals entail the regulation of the future market behaviours of the parties<sup>26</sup>. The ultimate purpose of the remedies is to maintain the existing competitive structure in the market prior to the transaction. Therefore, one can safely say that structural remedies are more suitable as a remedy<sup>27</sup>.

Finally, remedies may be offered during the preliminary investigation (along with the notification) or during the final review (after the notification). If the Board concludes that the transaction is not in contradiction to Art. 7 of the TAPC after considering the presence of a remedy proposal, then it will unconditionally permit the transaction without taking into account the proposed remedy.

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<sup>26</sup> Guideline on Remedies that are Acceptable by the Turkish Competition Authority in Merger/Acquisition Transactions explains the behavioural and structural remedy proposals. Also, see Nazlı Varol, *Rekabeti Kısıtlayıcı Birleşme ve Devralmalarda Çözümler ve Taahhütler*, Ankara 2009, p. 74 ff.; Cihan Bilaçlı, *Rekabeti Kısıtlayıcı Birleşme ve Devralmalarda Davranışsal Çözümler*, Ankara 2017, p. 40 ff.

<sup>27</sup> Guideline on Remedies That Are Acceptable by the Turkish Competition Authority in Merger/Acquisition Transactions, p. 6, show that the Board usually takes into account the structural remedy solution proposals. For the purposes of illustration, in its decision dated 17.11.2011 under no 11-57/1473-539, the Board has decided that competition problems that are seen in various geographical markets because of the acquisition may be sold if twelve theatres in these markets are sold (MARS/AFM decision). In its decision dated 06.04.2012 under no 12-17/458-M, the Board accepted the undertaking that Hare and Maestro brands, as well as the manufacturing sites in Bilecik, would be disposed of and sold and consequently permitted the acquisition (MEY ICKI-DIAEGO decision). Besides, for the acquisition of Migros by the Anadolu group, the Anadolu group made the commitment that it would sell products of Tuborg, its competitor in the beer sector, in Migros markets at competitive conditions and terms which meant equal terms applicable to Efes Pilsen products. This is a behavioural remedy (the decision rendered by the Competition Board on 09.07.2015 under no 15-29/420-117).

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## **JUDICIAL CONTROL OF SPATIAL PLANS AS PREREQUISITE OF ECONOMIC DEVELOPMENT IN CROATIA**

**Assistant Professor Mateja Held\***

### **SUMMARY**

*Spatial plans are local general acts, and according to the Art. 53 of the Spatial Planning Act (Official Gazette of Croatia 153/13, 65/17, 114/18) they are documents regulating organisation, purpose and utilisation of land and the conditions for the regulation, upgrade and protection of the land belonging to the state, counties, cities or municipalities. Spatial plans regulate the conditions for the construction of buildings and performing of other activities on certain location. They are general acts and are adopted as such by the local or regional council. Process of the adoption of spatial plans involves multiple participants and experts in the field. It also contains public discussions, confirmation of the relevant state authorities, all this provided by the Spatial Planning Act. Spatial plans should combine two different areas which involve public and private interests. Environmental protection and health of the citizens are some of the aspects of the public interest which should be respected by public investors. Participation of different participants in the process of the adoption of spatial plans is strengthening the supervision of the legality of the whole process, but on the other hand there is a space for potential irregularities to occur.*

*Control of legality of spatial plans is divided into two main areas, administrative control, which is exercised by the local administrative bodies such as mayors or state representative in regional units, and judicial control performed by the High Administrative Court of the Republic of Croatia. The speed of control of spatial plans affects the pace of the realisation of investments, thus affecting Croatia's appeal to investors. The subject of this paper is the analysis of the procedure before the High Administrative Court regarding the legality of spatial plans, the course of the procedure, and the question of how does this procedure affect protection of the fundamental rights of the citizens.*

**Key words:** *Spatial plan, judicial control, High Administrative Court, economic development.*

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## 1. INTRODUCTION

The Constitution of the Republic of Croatia

<sup>1</sup> and various documents on urban and physical planning contain provisions dealing with the process of developing and adoption of spatial plans. Spatial plans are general acts adopted by the local or regional representative body.<sup>2</sup> Spatial planning is an interdisciplinary area<sup>3</sup> closely connected to the construction management, planning of transportation routes, functioning of civil works, and land development. It includes feasibility studies, water resource management, traffic planning and studies, environmental protection, field services, geotechnical conditions, etc. Spatial plans can be considered a precondition of the development of local units, and the Spatial Planning Act (SPA) defines spatial plans as “*documents regulating organisation, purpose and utilization of land and the conditions for the regulation, upgrade and protection of the land belonging to the state, counties, cities or municipalities*” (Art. 53, SPA).

SPA is the basic act regulating spatial plans, but regarding significance of spatial plans for the development of local unit and the quality of life of citizens of local unit, numerous other sectoral acts and by-laws<sup>4</sup> contain provisions regarding protection of the environment, culture and sport, protection of the health of the citizens, protection of agriculture, forests and protection of waters, regulating utility management, sea, transport and infrastructure, energy industry and mining. While preparing a spatial plan, experts should consult relevant documentation regarding mentioned areas (Bienenfeld, 2006, p. 16). It should be noted that spatial plans are general acts, which makes them a base for delivering numerous individual acts which, in turn, determine

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<sup>1</sup> Official Gazette (hereinafter OG), no. 56/90, 135/97, 8/98, 113/00, 124/00, 28/01, 41/01, 55/01, 76/10, 85/10, 05/14.

<sup>2</sup> They can also be adopted on state level, but for purpose of the control over general acts, the focus of this paper will stay on local spatial plans “which are documents having the most significant influence on the shape of space order” (Rogatka & Tomczykowska, 2015, p. 26).

Silva and Acheampong (2015) claim:

„As regulatory instruments, local plans usually contain maximum and minimum land-use zoning standards, building standards and codes (e.g. building type and height), permissible development density and other local-level policies with which development in the areas they cover should comply. Local plans are mostly legally-binding and provide the basis to regulate development, construction and land use” (p. 24).

<sup>3</sup> See Article 2/1, para. 26 of the Spatial Planning Act, OG, no. 153/13, 65/17, 114/18.

<sup>4</sup> For example, Works and Activities of Physical Planning and Construction Act, Chamber of Architects and Civil Engineers in Construction and Spatial Planning Act, Assessment of Property Values Act, Regulation on State Plan of Spatial Development, etc. (More regulations available at [www.mgipu.hr/default.aspx?id=3655](http://www.mgipu.hr/default.aspx?id=3655), retrieved on 17<sup>th</sup> September, 2017).

the rights and obligations of citizens. It is of great importance for legality system in general that spatial plans are based on law, legally created and adopted.

Basic goal of spatial planning is the creation of the conditions for economic development, protection and management of the state territory, which was all the subject of the UN conference on environment and development in 1992. Sustainable development “*was declared to be a primary goal*” (Larsson, 2006, p. 7).<sup>5</sup> Larsson formulates goals from conference in eight categories: healthy and sanitary living conditions,<sup>6</sup> economic use,<sup>7</sup> meeting social needs,<sup>8</sup> accessibility,<sup>9</sup> protection of productivity,<sup>10</sup> preservation of environment,<sup>11</sup> preservation of cultural heritage,<sup>12</sup> public-private participation<sup>13</sup> (Larsson, 2006, pp. 7-8).<sup>14</sup>

This paper is divided into four main parts. The first part presents the structure of public administration and the structure of administrative courts. The second part deals with the stages of the spatial planning process and the importance of citizens' control in it. The third and fourth part of the paper analyze control of spatial plans which can roughly be divided into administrative and judicial. The main connections between judicial control and economic development are pointed out in conclusions.

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<sup>5</sup> The action program of the UN conference held in Rio de Janeiro in 1992 was called Agenda 21. The Agenda 21 was divided into four main sections: social and economic dimensions, conservation and management of resources for development, strengthening the role of major groups and means of implementation (Agenda 21, <https://sustainabledevelopment.un.org/content/documents/Agenda21.pdf>, retrieved on 19<sup>th</sup> September, 2017).

<sup>6</sup> In chapter 6 titled “Protecting and Promoting Human Health” it is stated: ‘The health sector cannot meet basic needs and objectives on its own; it is dependent on social, economic and spiritual development, while directly contributing to such development.’ (Agenda 21, para. 6.3).

<sup>7</sup> See chapter 2 “International Cooperation to Accelerate Sustainable Development in Developing Countries and Related Domestic Policies” (Agenda 21).

<sup>8</sup> See chapter 3 “Combating Poverty” (Agenda 21).

<sup>9</sup> Present in almost all chapters of the Agenda, referring to transportation (Larsson, 2006, 7-8).

<sup>10</sup> For example, prevention of deterioration of the land (Larsson, 2006, p. 8).

<sup>11</sup> Protection of the environment is the basic aim of the Agenda 21.

<sup>12</sup> For example stone walls, natural pastures and other (Larsson, 2006, p. 8).

<sup>13</sup> It refers to the cooperation of the government with citizens (Larsson, 2006, p. 8).

<sup>14</sup> This type of meeting was organized in 2012 in Rio de Janeiro and another Sustainable Development Summit was held in New York in 2015 (<https://sustainabledevelopment.un.org/rio20>, retrieved on 25<sup>th</sup> of September, 2017).

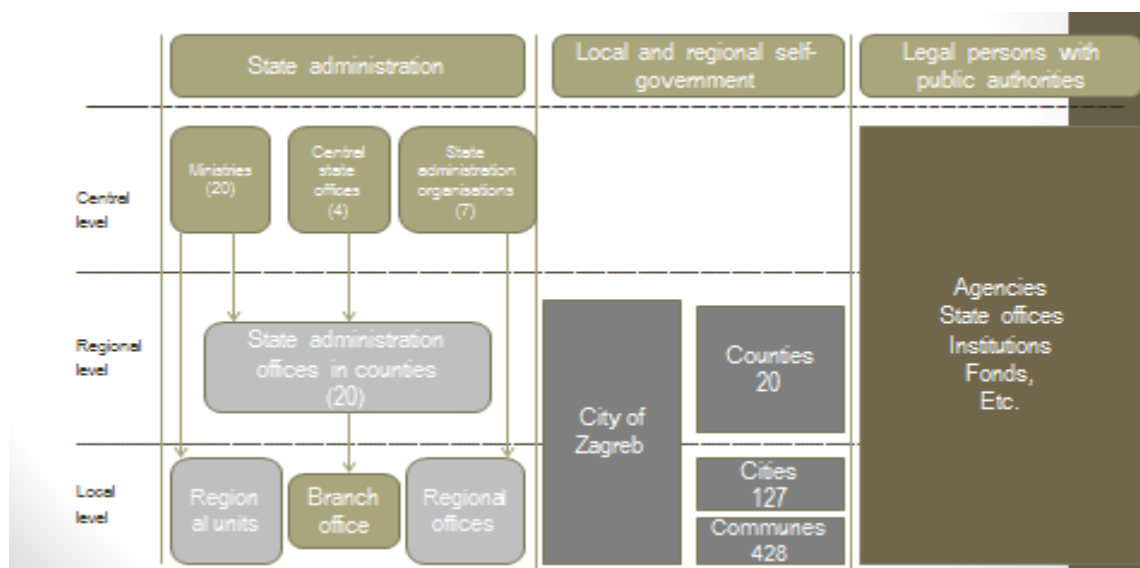


## 2. STRUCTURE OF PUBLIC ADMINISTRATION AND ADMINISTRATIVE COURTS IN CROATIA

### 2.1. Structure of Public Administration of Croatia

Croatia's public administration is organised in three levels: state, regional and local level. "Local political system established in 1993 is the one still existing, and consists of town and municipal councils (*gradsko i općinsko vijeće*) as local representative bodies and county assemblies (*županijska skupština*) as regional" (Koprić, Manojlović & Đurman, 2016, p. 10).<sup>15</sup> Picture 1 represents a simplified version of the structure of public administration. Spatial plans are adopted by the local or regional representative bodies,<sup>16</sup> but other bodies can also be involved in the process of the development and control of spatial plans.

Picture 1  
Structure of public administration in Croatia



Source: Strategy of the development of public administration for period 2015 – 2020 (OG, no. 70/2015. Retrieved from [www.nn.hr](http://www.nn.hr) on 29<sup>th</sup> September, 2017).<sup>17</sup>

<sup>15</sup> See more on territorial organisation of Croatia in: Koprić, 2015, p. 21-44.

<sup>16</sup> More on local self-government in Croatia see in: Koprić, 2010, pp. 665-681.

<sup>17</sup> Available in Croatian.

## **2.2. Structure of the Administrative Courts in Croatia**

Administrative Courts' system in Croatia is organised in two levels and regulated by the Administrative Disputes Act (hereinafter ADA).<sup>18</sup> First instance courts are situated in the cities of Zagreb, Rijeka, Osijek and Split (Art. 8, Areas and Headquarters of the Courts Act, OG 67/18). Administrative courts are entitled to perform control of legality of individual administrative acts and administrative contracts, and in their authority is the assessment of controls of conducting the procedure before administrative bodies and assessment of the omission of conducting the procedure before administrative bodies and other cases prescribed by the law (Art. 12/2, ADA). The High Administrative Court of the Republic of Croatia (hereinafter HAC) is the second instance administrative court with its seat in Zagreb. It decides on the appeals on judgements and decisions of administrative courts, on legality of general acts of local self-government, legal persons with public authorities and legal persons providing public service. It decides on conflict of jurisdiction of administrative courts, and in other cases prescribed by the law (Art. 12/3, ADA). The role of HAC in the control of spatial plans is explained in detail in the chapter on judicial review of spatial plans.

## **3. PROCEDURE OF ADOPTION OF SPATIAL PLANS**

Specificity of the control of the documents on spatial planning arises from the features of the spatial plan as the general act adopted by local representative body (Radman, 2014, p. 110). Since spatial plans are adopted on all three levels of territorial organization, it is very important that they are in conformity with law and Constitution, but also that one spatial plan is aligned with the other plans on different levels (Art. 61, SPA). A precondition for the control of general acts is publication in the Official Gazette (Crnković, 2015, pp. 80, 82, 100 and 183).<sup>19</sup> It is not just a precondition of their control but an obligatory condition for their legal strength as well. Citizens should be informed on spatial plans since the procedure of drafting spatial plan starts, throughout the whole process of the adoption of spatial plan and after the enforcement

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<sup>18</sup> More on organization of administrative courts' system in: Britvić Vetma, 2012, 389-412.

<sup>19</sup> Spatial plans can be published in the state official gazette called *Narodne novine*, or in the regional or local official gazette. It depends whether the act was adopted on state, regional or local level. It should be also considered that some local units do not have official gazette on their own, so they publish their general acts mostly in regional gazette.

of the spatial plan (Art. 64 - 65, SPA) and consequently control of spatial plans starts at the very beginning of the process of the creation of spatial plans.

### 3.1. Preparatory Activities in the Spatial Plan Drafting Procedure

Documents on spatial planning can be divided into three levels:<sup>20</sup> state, regional and local level according to the territorial organization of local and regional self-government (Art. 60, SPA).

Local representative body has the authority for the adoption of the local spatial plan, local general urban plan and local urban spatial planning (Art. 109, SPA). This provision derives from the Constitution of the Republic of Croatia (Art. 135) and Local and Regional Self-Government Act (hereinafter LRSGA, Art. 19-19a) where spatial planning is in local self-governing scope. It is in accordance with the European Charter of Local Self-Government and the principle of subsidiarity (hereinafter ECLSG, Art. 4/3).<sup>21</sup> General principles on spatial planning are the integral approach in spatial planning, appreciation of scientific and expert determined facts, spatial sustainability of development and quality of the construction, realization and protection of public and individual interest, horizontal integration in the spatial protection, vertical integration, transparency and access to data and documents relevant to spatial system (Art. 7, SPA).

Spatial plan consists of the provisions on implementation of spatial plan, graphic part and explanation of spatial plan, e.g. necessary analysis and goals of spatial planning (Art. 54/1, SPA). Local spatial plan can be spatial planning of the city or municipality<sup>22</sup>, general urban plan or urban spatial planning (Art. 60/4, SPA).<sup>23</sup>

It is very important that spatial plans are based on law, but also that they are in accordance with other regulations, which are above them according to their legal

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<sup>20</sup> See the structure of public administration *supra* in Picture 1.

<sup>21</sup> More on the principle of subsidiarity in: Lauc, 1999, pp. 463-467.

<sup>22</sup> Local self-government units are municipalities and cities (Art. 3/1, LRSGA).

<sup>23</sup> Three types of spatial plans differ in following. Spatial planning of the city or municipality is obligatory adopted for the area of the city or municipality and it refers to the construction area and following infrastructure (Art. 76, SPA). General urban plan is obligatory adopted for the construction area of the settlement and separated area outside the settlement (Art. 77, SPA). Urban spatial planning is obligatory adopted for an unfinished construction area, or an area where improvement or transformation is planned to be made (Art. 79, SPA).

strength.<sup>24</sup> The SPA regulates the mutual alignment of spatial plans with regard to the concerned area and their hierarchy. Spatial plan of a narrow area must be in accordance with the spatial plan of a wider area (Art. 61/3, SPA). Hierarchy of spatial plans requires that local plans are in accordance with regional plans, and regional must be aligned with the state spatial plans (Art. 61/2, SPA). Spatial plans of the same level must be mutually harmonized (Art. 61/4, SPA).

Adoption of spatial plans is a complex process<sup>25</sup> and this paper focuses on certain stages important for the control of legality of spatial plans, namely initiative for the delivery of spatial plan, proposal of the spatial plan and public discussion in the process of the adoption of spatial plans of the local level. Certain stages are described as much as it is necessary to understand the control over spatial plans.

There are two subjects which are relevant in the beginning of creation of spatial plans. Authorised body for the drafting of spatial plans performs expert tasks. On the local level, authorized body is an expert administrative body of the local self-government unit (Art. 81, SPA). Another subject is a so-called responsible manager for the draft proposition of spatial plan. He is responsible for the lawfulness of spatial plan and all other conditions set down by the law (Art. 82 – 83, SPA). His responsibility is to point out illegalities of spatial plan to the authorized body and to the ministry<sup>26</sup>.

### 3.1.1. Initiative for Spatial Plan Creation

According to the SPA, everyone is entitled to initiate creation of local spatial plan and its amendments. Mayor has an obligation to notify local representative body on the conclusions of the expert analysis of all initiatives at least once a year, with an aim of the starting the procedure of spatial plan creation (Art. 85, SPA).

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<sup>24</sup> Some authors represent a different point of view. For example, Račan believes that the principle of legality does not demand accordance of general acts of local self-government with other by-laws which are according to the legal strength under the law (Račan, 2006, p. 150).

<sup>25</sup> It is one of the most complex process in the scope of local units which can be treated at the same time as an obligation and as an authorisation for local unit (Bienenfeld, 2006, p. 18).

<sup>26</sup> Ministry is the central body of state administration with the authority in construction and spatial planning (Art. 3/1, para. 18, SPA). Currently in Croatia that is the Ministry of Construction and Spatial Planning ([www.mgipu.hr](http://www.mgipu.hr), retrieved at 26<sup>th</sup> September, 2017).

### 3.2. Decision on Spatial Plan Creation

Procedure on local level starts with the decision<sup>27</sup> of local representative body. Decision should be delivered to the Department of Physical Planning<sup>28</sup> and published in the local official gazette (Art. 86, SPA). Authorised body, after the decision has been published, should inform citizens on the website of the local self-government unit and through the information center of the Department of the Physical Planning. Neighbour cities and municipalities should also be notified on the creation of the spatial plan (Art. 88, SPA).

### 3.3. Citizens' Control in a Form of Public Discussion

Planning process is in most European countries considered a public responsibility and consequently everyone<sup>29</sup> is entitled to participate in the development of spatial plan with their suggestions, remarks, viewpoints, etc. However, the organization of the whole process of development of spatial plans is in the authority of local bodies, as representatives of local government (Larsson, 2006, p. 98).<sup>30</sup> They are included in the process for organization and utilization of the space in rational manner, which will result in the proper functioning of economic system of local unit in question (Gaczek, 2003, as cited in Miszczak, 2013, p. 106).

In Croatia, the mayor determines a proposal of local spatial plan. It contains textual and graphic part, explanation and summary for the public (Art. 95/1 - 95/2, SPA). A public discussion has to be announced<sup>31</sup> in the daily press and on the websites of the Ministry of Construction and Spatial Planning and local self-government unit (Art. 96/3, SPA), so everyone can participate in public discussion on the proposal of spatial plan with its opinions, suggestions and remarks (Art. 94/1 – 96/2, SPA).<sup>32</sup>

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<sup>27</sup> Decision should have legal basis of the creation and the adoption of spatial plan; reasons for the adoption of spatial plan; coverage of spatial plan; summarized assessment of the condition in spatial plan coverage; aims and program starting point of spatial plan; list of sector strategies, plans, studies and other documents regulated by sectoral laws, etc. (Art. 89, SPA).

<sup>28</sup> Each county has its own Department on Physical Planning and on the national level there is the Croatian Department on Physical Planning (retrieved from [www.hzpr.hr](http://www.hzpr.hr), on 29<sup>th</sup> September, 2017).

<sup>29</sup> Organizations, owners, developers and other citizens (Larsson, 2006, p. 98).

<sup>30</sup> Differences between European countries arise when spatial plan comes to the phase of implementation (Larsson, 2006, p. 98).

<sup>31</sup> Announcement contains the date and place of public discussion, the date of the beginning and duration of public insight into spatial plan proposal, and the deadline for the submission of suggestions, propositions and remarks on spatial plan proposal (Art. 96/4, SPA).

<sup>32</sup> See also Art.100 and 101, SPA.

Proposal of the spatial plan is presented for public insight on the notice board, on the website of the authorized body and also in the information system<sup>33</sup> of spatial planning (Art. 98, SPA). Its availability depends on the level on which the spatial plan should be adopted, and if local spatial plan amendments are in question, public insight has duration of minimum 8 and maximum 15 days. Exceptions are provided for e.g. maritime area, park of the nature, etc. (Art. 98/4).<sup>34</sup> Provisions on public participation are in accordance with the general trend in all European countries to increase public participation in spatial plan development, with the provisions in their regulation that has an obligation to present plan draft to authorities on higher level<sup>35</sup>, important organizations and citizens, with their right of reservation (Larsson, 2006, p. 53).

### **3.3.1. The Report on Public Discussion**

After public discussion is concluded, responsible manager and authorized body analyse the opinions, suggestions, and remarks brought out in the public discussion and they write a report on public discussion.<sup>36</sup> Deadline for the preparation of the report differs. If the spatial plan is new, it lasts for 30 days, and if the spatial plan is on amendment, the deadline is 15 days. A report should be published on the notice board and website of the authorized body (Art. 102, SPA).<sup>37</sup>

### **3.4. Final Proposition of the Spatial Plan**

A draft of the final proposition and the final proposition itself contain a textual part, graphic part and explanation. The draft is made by the Department of Physical Planning in cooperation with authorized body and it should be delivered to the mayor (Art. 105, SPA). Mayor determines the final proposition of spatial plan, but prior to the mayor's confirmation, participants should be informed on reasons of a rejection of their proposition and remarks on spatial plan (Art. 106, SPA). Before the adoption of the spatial plan, the Department of Physical Planning should give its approval in 15

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<sup>33</sup> Information system on spatial planning is interoperable and multiplatform system of all administrative bodies' information systems where they develop and store data on spatial planning in electronic form (Art. 31 – 37, SPA) and it is regulated in the Regulation on information system, OG, no. 115/2015. See also Article 4 of the Regulation for the same definition of information system.

<sup>34</sup> Deadline is 30 days (Article 98/4, SPA).

<sup>35</sup> If a country has a territorial division which includes regional or local level.

<sup>36</sup> All reports on public discussions in Croatia are available at: <http://www.mgipu.hr/default.aspx?id39882> (retrieved on 28<sup>th</sup> September, 2017).

<sup>37</sup> Contents of the report are regulated in the Art.103, SPA.

days. The Ministry of Construction and Spatial Planning should also give its approval (Art. 108, SPA).

### 3.5. Decision on Spatial Plan Adoption

Decision is adopted by the representative body of the local self-government unit and it is published in local official gazette (Art. 110, SPA). It contains sentence on the adoption of spatial plan with the name of spatial plan, provisions for the implementation of spatial plan,<sup>38</sup> list of cartographic diagrams,<sup>39</sup> name of the Department of Physical Planning,<sup>40</sup> deadline provisions, and the provision on the enforcement of spatial plan (Art. 111, SPA). Spatial plans should be available in electronic form (Art. 59, SPA).

## 4. ADMINISTRATIVE CONTROL OF SPATIAL PLANS

LRSGA is the basic act which in Section IX<sup>41</sup> and Section X<sup>42</sup> regulates general acts and the control over them. The general conditions upon which an act of a local unit can be considered a general act are regulated in the Article 73 of LRSGA. Local acts are adopted by the local representative body and they should be published in the local official gazette. General act enters into the force eight days after the publication and must not have retroactive effect (Art. 73, LRSGA).

Adoption of a general act is in a self-management sphere of a local unit.<sup>43</sup> Spatial planning is provided in the Art. 19 of LRSGA as self-management task of local units. Provision is in accordance with the principle of subsidiarity and ECLSG (Art. 4/3) and has some consequences, e.g., the state body should not exercise control of expediency, it can only perform control of legality and constitutionality (Koprić, Marčetić, Musa, Đulabić & Lalić Novak, 2014, p. 310).

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<sup>38</sup> Art. 114 – 124, SPA.

<sup>39</sup> „Cartographic representation of sustainable development is used to clarify the policy content for actors at national or regional levels“ (Dühr, 2005, p. 1169).

<sup>40</sup> In accordance with the name of territorial unit for which spatial plan is adopted.

<sup>41</sup> Section IX of the LRSGA is titled „Local and Regional Self- Government Acts“ (Art. 73 – 75).

<sup>42</sup> Section X of the LRSGA is titled „State Supervision and Protection of the Local and Regional Self- Government“ (Art. 78 – 89, LRSGA).

<sup>43</sup> Art. 135/1, Constitution of the Republic of Croatia.

Local general acts are controlled in four ways.<sup>44</sup> Three types of control are administrative and one is judicial. Administrative control is regulated in LRSGA. One local body, mayor, and two state bodies, namely State Administration Offices in counties and a competent Central State Administration Office on the state level in, have the authority to control spatial plans (Art. 79, LRSGA).

#### **4.1. Control by the Mayor**

Local representative body has an obligation to deliver general act to the mayor in 15 days from the adoption of general act (Art. 79/3, LRSGA). He can suspend general act if he finds the act unconstitutional or illegal with the decision on the suspension in eight days from the adoption of general act and can demand from a representative body to correct its mistakes in general act (Art. 42/3, LRSGA). If a local representative body ignores him, mayor will notify the Head of the State Administration Office in the County (Art. 42/4, LRSGA). Head of the State Administration Office in the County<sup>45</sup> will evaluate adequacy of the mayor's decision of the suspension of general act (Art. 42/5, LRSGA). If the Head of the State Administration Office finds mayor's decision on the suspension verified, he will bring a decision on confirmation of the mayor's decision of suspension. If mayor's decision is not verified, suspension of general act is no longer valid (Art. 80a, LRSGA).

#### **4.2. Control by the Head of the State Administration Office in the County and Central State Administration Body**

The local representative body has an obligation to deliver a general act to the Head of the State Administration Office in the County in 15 days from the adoption (Art. 79/2, LRSGA). If the Head of the State Administration Office finds the general act unconstitutional or illegal, they will give the instruction to the local representative body to correct illegalities. If the local representative body does not obey the instruction, the Head of the State Administrative Office will bring a decision on the suspension of general act (Art. 80a, LRSGA).

When the Central State Administration Body receives the decision of the Head of the State Administration Office in the County on the suspension or on the confirmation of the mayor's decision on suspension, he evaluates the adequacy in 15 days. If the

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<sup>44</sup> If citizens' control is not counted.

<sup>45</sup> Its scope of activities is regulated in Art. 55 – 59 of the State Administration System Act, OG, no. 150/11, 12/13, 93/16. 104/16.



Central State Administration body does not confirm the decision of the mayor or the Head of the Central State Administrative Body, it will abolish their decisions (Art. 80/b, LRSGA). If it confirms it, it will start procedure before the High Administrative Court of the Republic of Croatia (hereinafter HAC) for the assessment of the legality of general act.<sup>46</sup> Central State Administration Body will start the procedure before the HAC also if it independently<sup>47</sup> finds general act illegal (Art. 82, LRSGA).

Presented types of control over spatial plans are considered regular<sup>48</sup> and direct control over general acts.<sup>49</sup> Another type of the administrative control is indirect form of control in the form of consent<sup>50</sup>, of central state bodies.

## 5. JUDICIAL CONTROL OF SPATIAL PLANS

Judicial control over general acts is performed by the HAC.<sup>51</sup> The main result of the administrative reform in 2010 was the adoption of the new Administrative Disputes Act (hereinafter ADA).<sup>52</sup> According to the art. 3/2 of the ADA, subject of the administrative dispute<sup>53</sup> is the assessment of the legality of general act of local and regional self-government, legal persons with public authorities and legal persons providing public service. Spatial plans are adopted by the local or regional councils,<sup>54</sup> meaning the HAC has the authority for the assessment of its legality.

Procedure starts before the HAC in 30 days from the delivery of the individual decision – an administrative act which was based on the spatial planning act and which violates rights or interests of an individual person (Ivančević, 1983, p. 231).

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<sup>46</sup> Assessment of the legality of general acts is regulated in the ADA in the art. 83 – 88.

<sup>47</sup> Art. 180 – 185 of the SPA regulate supervision by the Ministry of Construction and Spatial Planning as the Central State Body without mentioning judicial control by the HAC.

<sup>48</sup> Some authors prefer expression “anticipated control” instead regular control (Antić, 2013, p. 227).

<sup>49</sup> More on the regular control of general acts see in: Kasabašić, 2006, pp. 6-7.

<sup>50</sup> Before the adoption of local spatial plan, the Ministry should give its approval on the spatial plan (Art. 108, SPA). The mentioned provision is violation of local autonomy because it presents infringement of local self-management scope of activities guaranteed by the Constitution and LRSGA by the Central State (More in: Radman, 2014, pp. 115-126).

<sup>51</sup> The HAC has its seat in Zagreb. Data available on: <http://www.upravnisudrh.hr>, last consulted on 29<sup>th</sup> September, 2017.

<sup>52</sup> Most important viewpoints of the administrative courts' reform and the new Administrative Disputes Act see in: Medvedović, 2012, pp. 15-75 and Đerđa, Šikić, 2012.

<sup>53</sup> More on definition of the administrative dispute see in: Krbek, 2003, p. 229.

<sup>54</sup> Art. 35/2 of the LRSGA and art.86/3 of the SPA.

Proceedings are conducted *ex officio* if they are initiated by citizens' notice, ombudsman or on the court's request.<sup>55</sup>

Request for initiating the procedure before the HAC must contain the name and address of applicant, the name of general act and the name of a public body which adopted the general act. The applicant must emphasise provisions of the general act which are unlawful by its opinion and reasons for unlawfulness. The applicant must sign the request and he also must make violation of citizens' rights probable (Art. 84/2 ADA).

The HAC decides in councils of five judges in public session (Art. 14/2 and 86/1, ADA; Vezmar Barlek, 2013, pp. 55 and 57-58). If the HAC finds an act unlawful, it will abolish the act (Art. 86/3, ADA). The judgement will be published in the Official Gazette of the Republic of Croatia (Art. 86/4, ADA). Such regulation has enormous consequences on spatial plans. If a spatial plan is abolished by HAC, and after the judgement of HAC is published in the Official Gazette, the spatial plan is no longer valid. Invalid act can produce no legal effects.<sup>56</sup> Spatial plan can no longer be the basis for the delivery of the individual administrative act which could affect the rights or obligations of the citizens. Spatial plan should have no legal consequences at all.

The HAC has the authority to abolish general act in question, if it finds that the general act is unlawful. Consequences described above should be distinguished from the consequences of annulment of an act. The HAC is not entitled to annul general act because the Constitutional Court is the only court which has the authority for the annulment of the general acts in exceptional cases (Art. 55/3, Constitutional Act on Constitutional Court).<sup>57</sup> It should be noted that spatial plans are not subject of supervision before Constitutional Court, so sanction for their irregularities is abolishment by the HAC.<sup>58</sup>

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<sup>55</sup> Art. 83 of the ADA.

<sup>56</sup> With the annulment of the act, act produces no effects *ex tunc*, and with the abolishment *ex nunc* (Borković, 2002, p. 395).

<sup>57</sup> Prior to the administrative courts' reform, control of local general acts was under the Constitutional Court's authority (Omejec, Banić, 2012, pp. 310-315).

<sup>58</sup> The SPA regulates the legal nature of spatial plans as „subordinate regulations“ (Art. 58/1, ASP), and not as general acts. It is an important difference since subordinate regulations are within Constitutional Court's authority, and general acts within HAC's authority. The division is made on the body which has authority for the adoption of general act. Legal nature of spatial plans should be determined with respect to principles set down in ECLSG, especially the principle of subsidiarity and local autonomy. For violation of local autonomy see: Medvedović, 2005, p. 102, Koprić, 2000, pp. 391 – 436.

In three months since the judgement was published, applicant (meaning only a person who started the procedure before HAC) can ask public administrative body which has issued the decision (administrative act) to abolish an individual decision based on the unlawful general act (Art. 87, ADA).

The HAC has the authority to suspend the procedure of assessment of the legality of general act if applicant withdraws its request (Art. 88, ADA).

At first, such a regulation seems maybe too strict, but if one considers a complicated and interdisciplinary process of the delivery of spatial plans and control mechanisms such as citizens' public discussion, direct and indirect administrative control, presented regulation seems justified.

### 5.1. Enforcement of the Judgements

When dealing with the enforcement of administrative courts' judgements, it has to be noted that the administrative dispute conducted before administrative courts has a lot of features which distinguish it from all other procedures such as civil or criminal procedure.<sup>59</sup> Plaintiff is mainly a public body which has violated party's right or legal interests. The main task of the administrative court procedure is to eliminate illegalities from the legal system (Đerđa, 2015: 136). Art. 10 of ADA regulates:

*“(1) Judgements of the administrative courts are binding for both parties in the court procedure and for their legal successors.*

*(2) High Administrative Courts judgements are binding for everyone.”*

The difference between those two provisions is based on the nature of the court proceedings as they can be divided into subjective and objective.<sup>60</sup> The centre of the subjective administrative dispute is the administrative act and the aim is to protect individual rights and freedoms of the citizens. Administrative act is an individual decision on rights, obligations or legal interests of an individual person. If it violates

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<sup>59</sup> Administrative dispute is „construction of the theory and practice from the beginning of the 19<sup>th</sup> century, created for the protection of the objective legality and protection of the subjective rights of the citizens.“ It is a form of the judicial control of the administration and administrative acts (Borković, 2002, p. 483).

<sup>60</sup> See more on the conceptions of the administrative dispute in: Crnković, 2015, pp. 693-719. Administrative dispute can be divided into the administrative dispute on legality and dispute of full jurisdiction on one hand, and on primary dispute and subsequent dispute on the other (Ljubanović, Britvić Vetma, 2011, pp. 753-772).

rights or interests of an individual person, it can be questioned on an appeal level of public administrative body,<sup>61</sup> and decision of the appeal body is one of the subjects of the assessment of legality before administrative courts. Administrative courts are conducting subjective administrative dispute and their judgement is a decision on subjective rights of the citizens.

Objective administrative dispute was introduced in Croatian legal system after administrative courts' reform in 2010. Objective dispute is regulated in Art. 83-88 of the ADA. The subject of the objective administrative dispute is a general act (for example, spatial plan) and the main aim is the protection of objective legal system. Since general acts have general effects, judgements reached in objective administrative dispute are binding *erga omnes* (Šikić, 2012, p. 419), wherefrom binding legal force of judgement arises. The judgement can be enforced after it is delivered to the party. Publication of the judgement does not affect the enforcement of the administrative courts' judgement (Šikić, 2012, p. 419).

Problems with the legality and the enforcement of HAC judgements can be seen in the following example. A judgement of the HAC of 28<sup>th</sup> November 2014 (Usoz-96/12-8) can be used as an example of the abolishment of spatial plan. The Spatial plan of Dubrovnik – Neretva County was changed illegally and the HAC abolished the changes of the plan. The problem regarding Dubrovnik – Neretva spatial plan is far more complex than it might seem at first. The Investor of the "Golf Park Dubrovnik" project presented the project<sup>62</sup> as a recreational centre with pertinent infrastructure. Multiple problems appeared, such as costs of the infrastructure,<sup>63</sup> protection of cultural heritage, and so on. The golf project should be situated in the area of Fort Imperial on the mountain of Srđ, which is of great historical significance for the city of Dubrovnik and its citizens.<sup>64</sup> The problem with the implementation of the HAC judgement is ongoing.

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<sup>61</sup> Appeal in the administrative procedure is regulated in art. 105-121 of the General Administrative Procedure Act.

<sup>62</sup> See more on project from the investors' side: <http://www.golfparkdubrovnik.hr/en/view/urban-development-plan-of-the-srd-plateau-/18>, retrieved on 13<sup>th</sup> September 2017.

<sup>63</sup> Most of the costs of this infrastructure will fall on the citizens of Dubrovnik since current regulation in laws and by-laws prescribe that local unit should cover the expenses from its local budget, unless the investor and local unit make a contract with different regulation of costs (Art. 75 of the Utility Management Act, Art. 59, 125, 197/5, 197/8, 205/2, 212/2, 214 of the Water Act, Article 24/5 of the Electronic Communications Act, etc).

<sup>64</sup> Construction of the fortification Imperial started during French occupation in 19<sup>th</sup> century. Mountain Srđ had its military significance back then as well as during the war in Croatia in the beginning of

The above-mentioned problem is not an isolated case. The HAC was active in the task of objective legality, which can be observed in the following table.

Table 1

Assessment of the legality of spatial plans before HAC (2015 – 2017)<sup>65</sup>

High Administrative Court	Number of cases	Accepted (abolished decision)	Refused	Rejected	Suspended
2015	6	0	3	3	0
2016	12	1	0	7	4
2017 <sup>66</sup>	3	1	1	/	1
Total	21	2	4	10	5

Source: Author's research.

In 2015 the HAC was deciding on the legality of spatial plans in six cases.<sup>67</sup> Three of them were refused, three rejected, and there were no cases of accepted request or suspended procedure. In 2016 of a total of 12 requests<sup>68</sup> only one was accepted, meaning that the spatial plan was illegal. In seven cases the request was rejected and in four cases the procedure was suspended. In 2017 three requests<sup>69</sup> were dealing with the legality of spatial plans. One was accepted, one refused and in one case the procedure was suspended. Of a total of 21 requests on legality of spatial plans, the majority was rejected for several reasons.<sup>70</sup> The Usoz-96/12-22 Decision of 20<sup>th</sup> December 2016 confirms problems regarding enforcement of HAC's judgements, although they have *erga omnes* effect.

1990s..On historical significance of the fortification Imperial more in the monumental study by Harris, 2006, p. 405.

<sup>65</sup> Although the HAC was established in 2012, the assessment of the legality of general acts started in 2013 (retrieved from: <http://www.upravnisudrh.hr/frames.php?right=ocjenazak.html>, on 29<sup>th</sup> September 2017). For HAC's judgements on spatial plans prior to 2015, see Crnković, 2015, pp. 228-233.

<sup>66</sup> Data reviewed on 29<sup>th</sup> September 2017.

<sup>67</sup> Usoz-49/14-6, Usoz-73/12-9, Usoz-262/13-5 (session held on 12<sup>th</sup> June 2015); Usoz-113/15-5 (session held on 25<sup>th</sup> September 2015); Usoz-107/15-6 and Usoz-110/115-6 from 30<sup>th</sup> November 2015).

<sup>68</sup> Usoz-103/15-9 from 24<sup>th</sup> February 2016; Usoz-86/14-5, Usoz-310/13-6, Usoz-345/13-5 of 29<sup>th</sup> April 2016; Usoz-56/2016-RO.A., Usoz-57/2016-RO.A., Usoz-58/16-4, Usoz-59/16-7 of 23<sup>rd</sup> September 2016; Usoz-11/16-5, Usoz-163/15-5 of 25<sup>th</sup> March 2016; Usoz-35/16-5, Usoz-124/2015-5 of 13<sup>th</sup> June 2016.

<sup>69</sup> Usoz-73/16- 11 of 28<sup>th</sup> February 2017; Usoz-112/16-7 of 30<sup>th</sup> March 2017, Usoz-116/16-6 of 25<sup>th</sup> April 2017.

<sup>70</sup> Reasons for the rejection were the absence of an individual decision, the act in question was not considered a general act, and that the act in question did not have content prescribed by the law.

## **5.2. Control of HAC's Judgements on the Legality of General Acts**

HAC's judgements can be the subject of control before the Supreme Court of the Republic of Croatia, and the Constitutional Court in its decision U-III-4035/2013 of 28<sup>th</sup> January 2016 allowed a constitutional complaint against HAC's judgements on the legality of general act. With more control bodies, the procedure of assessment of legality of general acts becomes more complex (Šikić, 2017, 194). Šikić (2017, p. 194) maintains that the mentioned standpoint of the Constitutional Court „was a welcome relief since no one has ever exercised control over HAC's judgements prior to the mentioned decision“.

## **6. CONCLUSIONS**

Spatial plans are complex interdisciplinary general acts adopted by the local representative bodies. The complexity of general acts produces a few types of control over spatial plans. The control over spatial plans starts already at the beginning of the planning process. Citizens have the initiative for the necessity of spatial plans and play an important role in the process of the adoption of spatial plans, especially through the form of public discussion with its opinions, suggestions and remarks on the proposal of spatial plan (Art. 94/1 – 96/2, SPA).

Administrative control exercised over spatial plans can be divided into two main types: indirect control (in a form of approval of state administrative bodies) and direct and regular control (in a form of supervision by local and state administrative bodies prescribed by the LRSGA). It is worth mentioning here that the indirect control, which is performed by state administrative bodies, can be interpreted as a violation of the local self-government's autonomy guaranteed by the Constitution. Local units lie at the core of the state's development. “Cities represent the real foundation of development as only they have adequate and concentrated human, technical and infrastructural, financial, creative and other potentials” (Koprić, 2015a, p. 996). If their local autonomy is infringed, economic development can hardly be expected.

In the current regulation, spatial plans are also controlled by the High Administrative Court in the objective administrative dispute (Art. 3/2 and 83-88, ADA). Courts are the most suitable institutions for performing the mentioned task because of their impartiality and because judicial control is generally the most important type of control performed over the administration (Borković, 2002, p. 129). Judgements of the

High Administrative Court with *erga omnes* effect are legally binding for everyone, that is to say this includes all participants of the spatial planning process, as well as potential investors. An illegal spatial plan violates the rule of law and interests of all citizens, especially if it infringes resources such as water, biodiversity, and so on. The consequences of illegal spatial plan will firstly affect the citizens of a local unit, directly or through illegal individual administrative act based on the illegal spatial plan.

Judicial control, as impartial control over spatial plan, enables legal management of the land and legal individual acts based on spatial plan with decisions on rights and obligations of the citizens. Consequently, it can create suitable surroundings<sup>71</sup> which may prove to be a magnet for domestic and foreign investors into Croatia, with the overall result in the economic progress of the country.

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<sup>71</sup> Miszczak (2013, p. 112) maintains: „Spatial planning needs to be linked to initiatives targetting enterprises and job creations“.

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# ECONOMIC POTENTIAL OF CREATIVE AND CULTURAL CONTENT IN THE DIGITAL SINGLE MARKET – CHALLENGES FOR THE FUTURE OF THE COPYRIGHT LAW IN THE EUROPEAN UNION

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## SUMMARY

*Several studies that analysed the European Union's creative and cultural industries showed that creative and cultural industries have the most prominent growth in comparison to the general economy. They also intensively contribute to the European GDP and employment. The creative and cultural industries also showed that they are extremely resistant to crisis. The economic impact of creative and cultural industries led the decision makers across the European Union to the prevailing viewpoint that the creative and cultural industries deserve special attention in the context of economic development of the European Union and the development of the European Digital Single Market. Since the copyright law tailors and enables the legal framework for the protection of creative and cultural content of all kind, the Copyright reform was implemented on the European level in order to settle the most problematic issues of copyright protection in the Digital Single Market. This text analyses the problematic legal issues of copyright protection, such as the territoriality of copyright, the concept of communication to the public in the digital environment, the problem of "intermediaries" and "safe harbours", as well as the problem of the "value gap", and the way in which the Copyright reform, currently in the legislative procedure before the institutions of the European Union, proposes to settle those issues.*

## 1. INTRODUCTION

There is a relation between the creative and cultural content and the economic growth. This relation can also be viewed in the context of legal framework for the protection of cultural and creative content, namely the copyright law (the term 'copyright' generally means copyright and related rights). Simply put, the copyright law tailors and enables the legal framework for the protection of creative and cultural content of all kind, including, in particular, the prevention of unauthorised uses of cultural and creative products and the facilitation of financial gain derived from authorised uses of cultural and creative products. The term 'creative and cultural content' or 'creative and cultural products' primarily encompasses musical and audiovisual works, performances, and

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phonograms or videograms, but it also includes all other kinds of work eligible for copyright protection, such as photos, video games, drawings, all kinds of pictures created with or without the support of different technical means as well as computer programs. Media content also falls within the scope of the term 'creative and cultural content'.

The general justification of copyright protection is that the authors and other creators of creative and cultural content, and the creative and cultural industries, which enable and organizationally and financially support the creation and distribution of the creative and cultural content towards the end users, deserve legal protection in relation to their creations and should be duly financially awarded because their work and effort significantly contribute to the common well-being. Bently and Sherman summarised the five justifications for the existence of copyright protection, which are developed and explained in a large body of literature: natural rights of the creators, reward for the creation, incentive-based theories, neo-classical theories and democratic arguments. (Bently, Sherman, 2009, pp. 34-39). However, creativity and innovation are widely recognised as key to business and economic success and incentives for economic growth in the contemporary world. This is also well recognised in the very foundation of the strategical approach to the future existence and development of the European Union (Europe 2020). Since the existing copyright legal framework in the context of the European Digital Single Market was recognized as not satisfactory in relation to achieving the said goal and facilitating the creation and the further development of the European Digital Single Market, European institutions dedicated a serious amount of effort in adapting the copyright legal framework to the digital circumstances “by modernising copyright rules in the light of the digital revolution and changed consumer behaviour” (Junker, 2014). Moreover, the copyright reform is currently carried out in order to fulfil the main goals of the Digital Single Market Strategy for Europe (2015). It seems that the legal texts, currently in the phase of a trilogue between the European Commission, the European Parliament and the European Council, will be shaped in a way which shall turn the steering wheel towards the supportive legal framework for a better copyright protection of creative and cultural content in the digital environment and their better economic evaluation and better commercialisation. Those efforts should contribute to better functioning of the Digital Single Market and economic development of the European Union.

## 2. COMMERCIAL VALUE OF CREATIVE AND CULTURAL CONTENT

Cultural and creative products protected by copyright usually, as such, have some commercial value. This value varies depending on many different factors and variables. One very important factor, which usually affects the commercial potential of some cultural or creative products, is language. Products created in well spread languages are perceivable to a larger public. The modes of expression and, consequently, the available channels of distribution can also affect the commercial value of creative and cultural products. For example, the theatrical works shall be less exposed to the general public because of their modes of expression and channels of distribution than the motion pictures. Therefore, the financial gain from the exploitation of successful theatrical works shall be usually tremendously smaller than the gain from a successful motion picture based on the same story. This primary value of creative and cultural products protected by copyright shall usually be measured on the market in terms of revenue collected from their exploitation for the benefit of their creators and other owners of copyright.

Besides this primary commercial value, which usually serves to their creators and other owners of copyright, cultural and creative products regularly have very important commercial side effects on the general economy. This might be seen as the secondary value of cultural and creative products protected by copyright. For example, in tourism the most popular destination regularly includes cultural and creative products as an important part of the touristic offer that highly increase the attractiveness of a particular destination. There are also many other examples and many other variables which affect the commercial values of cultural and creative products. Therefore, cultural and creative products are an important incentive for economic growth.

In addition, cultural and creative products protected by copyright should not be observed solely through the pure commercial prism because they have also very important social aspects. They affect the social environment and social life in the widest sense since cultural and creative tangible and intangible products are an important medium of everyday socialisation. For example, today social communication very often occurs through music, audiovisual products (*e.g.* video games) and photography. Therefore, cultural and creative products are also an incentive for social growth. Consequently, social growth generally leads to economic growth.

Nevertheless, it is much easier to say than to prove the above statements on the importance of cultural and creative products as incentives to economic growth. In this context, it is important to remember the saying which some attribute to Albert Einstein and some to **William Bruce Cameron**: “Not everything that counts can be measured and not everything that can be measured counts.” or “Not everything that counts can be counted, and not everything that can be counted counts.” These sayings served as the motto in the analysis on the economic impact of cultural and creative industries in Europe (KEA, 2006, p.5).

There are also creative and cultural products that fall within the public domain because their copyrights expired. They do not commercially contribute to the benefit of their previous copyright owners, their heirs and other legal successors. Nevertheless, even in those situations, those cultural and creative products usually create commercial benefit for society in general, on the local, regional and/or national level.

### **3. OVERVIEW OF THE ECONOMIC STUDIES ON CREATIVE AND CULTURAL INDUSTRIES**

Since the usual methodologies for the measurement of economic value of material products and “usual” services, and the impact of some industrial branches on the GDP and economic growth cannot be applied to cultural and creative products, services and industries, different new methodologies were developed in last decades in order to precisely measure their economic value and impact to the GDP and economic growth in general. Those new methodologies were developed in a way that enables comparison in time and comparison between different markets and different industries. Among several widely accepted models, the most widely used are the DCMS model and the WIPO model.

The UK Government’s Department for Digital, Culture, Media and Sport (DCMS), which was established in the last decade of the twentieth century, developed one of the most prominent and accepted methodologies for the measurement of value of cultural and creative products. Within this methodology, creative industries are “those industries which have their origin in individual creativity, skill and talent and which have a potential for wealth and job creation through the generation and exploitation of intellectual property.” (Creative Industries Economic Estimates 2016, Creative



Industries Mapping Documents 2001). A value measured within this methodology is the Gross Value Added (GVA), which represents the amount that individual businesses, industries and sectors contribute to the economy, exports and employment. Ayoubkhani (2014) explains that the “Gross Value Added (GVA) is a component of a Gross Domestic Product (GDP) – a measure of economic activity within the UK. It is a key measure of economic performance produced by the UK National Accounts and, under the production approach to estimation, is calculated as the difference between the values of the output (goods and services produced) and the intermediate consumption (goods and services used up in the process of producing the output) within the economy.”

While the DCMS model is more oriented towards human creativity and its contribution to the economy, the World Intellectual Property Organisation (WIPO) model of measuring the value of cultural and creative industries puts copyright in the centre as the right that protects cultural and creative products. The WIPO methodology measures the impact of copyright-based industries (WIPO, 2015), which are divided into four categories: core copyright industries, *i.e.* “industries which are wholly engaged in the creation, production and manufacture, performance, broadcasting, communication and exhibition, or distribution and sale of works and other protected subject matter.” (WIPO 2015, p. 51.), interdependent copyright industries, *i.e.* “industries which are engaged in the production, manufacture and sale, and renting or leasing of equipment. Their function is wholly or primarily to facilitate the creation, production, or use of works and other protected subject matter.” (WIPO 2015, p. 59), partial copyright industries, *i.e.* “industries in which a portion of the activities is related to works and other protected subject matter and may involve creation, production and manufacture, performance, broadcasting, communication and exhibition, and distribution and sales.” (WIPO, 2015, p. 60) and non-dedicated support industries, *i.e.* “those in which a portion of the activities is related to facilitating broadcast communication and the distribution or sale of works and other protected subject matter whose activities have not been included in the core copyright industries.” (WIPO 2015, p. 62). All of the four categories of copyright-based industries were taken into account when measuring their united economic impact.

In the Republic of Croatia, the WIPO model was applied for the years 2002 and 2004. It showed that copyright-based industries were contributing to the 4.424% of the Croatian GDP for the year 2002 and to 4.272% for the year 2004. The analysis showed

that copyright based industries participated in the employment of 4.227% for the year 2002 and of 4.645% of the active population for the year 2004 (WIPO, 2007).

In 2015, a new study was developed in Croatia, where the Institute of Economics from Zagreb developed its own methodology based partially on the DCMS methodology. Here, due to the difference in methodology and the inclusion of different industries, the results showed that the creative and cultural industries participate with 2,3% in the GDP and with 3,0% in the employment (7,1% when using the DCMS methodology). (EIZ, 2015). The results differ from 2002 and 2004 in relation to 2015 mostly because of the different methodologies used.

Ernst & Young conducted a similar study commissioned by GESAC in 2014, in which they used their own methodology according to which creative and cultural industries “comprise those industries producing or distributing cultural and creative goods and services, defined in 2005 by the UNESCO as activities, goods and services, which... embody or convey cultural expressions, irrespective of the commercial value they may have.” They adopted a sector-based approach in order to take the specifics of each industry into account. Therefore, the report covers 11 sectors. This study was based solely upon revenues from the cultural industries and took no account of indirect impacts upon related economic activities such as tourism. It encompassed the EU28. (E&Y 2014, p. 96). When comparing the results from Croatia with the results for the whole European Union presented in E&Y study, Croatia appeared to be average. Namely, the results of the Ernst & Young study showed that creative and cultural industries with revenues of €535,9 billion contribute to the 4,2% of the European Union’s GDP. At the same time, more than 7 million Europeans were employed in this sector, which represented the 3,3% of the European Union’s active population in 2014.

Eight years earlier, in 2006, KEA conducted another research commissioned by the European Commission and found out that in 2004 the creative and cultural sector generated a turnover of more than €654 billion, which represented a 2,6% of the European Union’s GDP at that time. In 2004, 5,8 million people worked in this sector, which represented the 3,1% of the total employed population in the European Union.

Both of the studies which analysed the European Union’s creative and cultural industries showed that creative and cultural industries have the most prominent and intensive growth in comparison to the general economy. According to the KEA study, the overall growth of the creative and cultural sector’s value added from 1999 to 2003 amounted to 19,7%, which was 12,3% higher than the growth of the general economy.

Creative and cultural industries also showed that they were extremely resistant to crisis. In the period of economic hardship in 2008 and in the following years, the creative and cultural sector showed exceptional resilience. According to the Ernst & Young study, while job creation in Europe was falling by 0,7% per year in the period between 2008 and 2012, the job creation in creative and cultural industries was growing by 0,7% per year.

Among others, the said results on the economic impact of creative and cultural industries led the decision makers across the European Union to the prevailing viewpoint that the creative and cultural industries deserve a special attention in the context of the economic development of the European Union.

#### **4. MAIN LEGAL PROBLEMS WHICH CAUSED NEGATIVE COMMERCIAL IMPACTS TO CREATIVE AND CULTURAL INDUSTRIES IN THE DIGITAL ENVIRONMENT**

As said, the institutions of the European Union, the governments, and other decision makers in the Member States have noticed the explained economic, but also the social and cultural potential of creative and cultural industries and their unavoidable intensive impact on the European Single Market and, in particular, the European Digital Single Market. In this context, the copyright law, as the legal framework for the protection of creative and cultural products, was recently seriously re-examined on the European level. The general conclusion was that the present legislative and, in particular, enforcement situation was far from satisfactory, especially from the perspective of the copyright owners. They emphasise that the emerging development of the European Digital Single Market and the new business models of exploitation of cultural and creative products brought about the so-called value gap. This is the gap in commercial value gained by online digital platforms, which are intermediaries between the creators and the users of cultural and creative content, and the commercial value gained by the creators, namely the cultural and creative industries. *E.g.* IFPI asserts: "The sustainable and balanced growth of the digital content market continues to be undermined by a fundamental flaw in legislation underpinning the market that has created a 'value gap', a mismatch between the value that online user upload services, such as YouTube, extract from music and the revenue returned to the music community." It also emphasises that the inconsistent applications of online liability

laws have emboldened certain digital platforms to claim that they are not liable for the music they make available to the public.

Therefore, it was concluded that some moves need to be drawn on the European level, within the competences of the European Union, since the business models of the exploitation of cultural and creative products are changing practically on the daily basis and the existing legal framework has proved itself insufficiently effective. Nevertheless, the direction, the content and the intensity of those moves has not always been clear. The European Commission presented the package of legislative measures that should improve the legal framework of the copyright protection and adapt it to the contemporary needs of the developing European online market. This package was well “shaken” in two fora of the European institutions: before the Council of Europe, before the European Parliament. At the time of writing this paper, it is in the phase of trilogue between the Commission, the Council and the Parliament. The final content of the existing legislative proposals are yet to be seen. A certain amount of time has to pass in order to see whether the said legislative initiatives shall bring along a better ratio in financial gains between all of the players in the business of production and exploitation of creative and cultural content in the digital environment.

As said, some traditional legal framework applied in the digital environment has caused multiple negative commercial impacts since the exploitation of creative and cultural content protected by copyright and related rights over the Internet faced completely new business models. Therefore, the European copyright reform is, among others, targeting the issue of negative impact of present business models and interpretation of the particular provisions of the existing European directives to those business models. The weaknesses of the European (and national) copyright legislation revealed themselves especially in combination with the general principle of territoriality, general rules on the electronic commerce and on the jurisdiction and the choice-of-law regulations, as described below.

#### **4.1. Territoriality and exclusive rights**

Since the traditional legal framework for copyright and related rights was generally well balanced and the copyright works and the subject matters of related rights were well protected through the systematic approach, both on the international and national level, there were basically no important disturbances in the legal protection of copyright and related rights from the historical point of view. The periodical

appearance of new technologies did raise some questions during the history of copyright, but the stakeholders, including the competent authorities, courts and academics regularly managed to settle those questions and the copyright legal framework contributed to the development of creative and cultural sector. The principle of territoriality and the principle of exclusive rights were the pillars of copyright protections from the beginning of the copyright legislation. The former confirms that the copyright protection is given on a country by country basis where the country's law on protection was regularly applied and widely accepted as the rule. The latter confirms that the owners of copyright have the right to allow or to forbid the use of the protected content under the conditions settled by the right owners, which regularly include the right to be remunerated for each and every use of the protected content.

#### **4.2. Right of communication to the public in digital environment**

On the eve of the appearance of new digital technologies and a wide spread use of content protected by copyright in the digital environment, there were serious discussions on the re-examination of the legal framework of copyright and related rights in the digital environment on the international and European level. The results of those debates on the international level were shaped in the form of the WIPO Internet Treaties from 1996 (Ficsor, 2002) and on the European Union level in the form of InfoSoc Directive from 2001 (Walter, Lewinski, 2010). Both legal instruments confirmed the principle of territoriality and the principle of exclusive rights, which means that the traditional legal principles of copyright protection should also be applied in the digital environment. Moreover, with this respect, the said legal instruments introduced the definition of the new right of making available to the public as the part of the widely recognised and contently unlimited right of communication to the public. This new making available to the public right should have strengthened the position of the right owners in respect of the "on demand" uses of protected works and subject matters of related rights. Surprisingly, this new exclusive right of making available to the public did not raise any special doubts and questions during the last years of its wide application in interactive communications over the Internet. On the other hand, the definition and the scope of the right of communication to the public, as a wider concept recognised from the very beginnings of the copyright protection, raised many problems, questions and doubts. Since there is no single and unified definition of the right of communication to the public, there is a lot of space for different understandings and different interpretations, especially in

connection to the new forms of communication to the public developed in the light of technology development and change of business models in the exploitation and consummation of creative and cultural content. In addition, the Court of Justice of the European Union sometimes contributed to this ambiguity of the right of communication to the public in the digital environment by applying different criteria in deciding whether a particular act forms the communication to the public. It defined the scope of the right of communication to the public in the digital environment mostly by taking into account the specific circumstances of the respective factual situations, by defining the “public” and by putting into perspective the specific factual situations the “complementary criteria” in assessing the scope of this right. Those complementary criteria are “the profit-making nature of the activity”, “intentional, deliberate and indispensable intervention by the operator”, “the existence of new public” and the “existence of new technical means different from that of the original communication” (Xalabarder 2016, p. 636). One should bear in mind that the economic consequences of different interpretations of the application of the right of communication to the public in the digital environment can be tremendous with regard to the revenues of the right owners. One good example is the judgement in the case of SBS Belgium (ECLI:EU:C:2015:764) where SABAM (Belgium collective management organisation for music authors and publishers) was denied the claimed remuneration of approx. 1 million Euros for the year 2009 for music copyright because the act of so-called direct injection was not interpreted as the act of communication to the public on the side of the broadcasting organisation “...when it transmits its programme-carrying signals exclusively to signal distributors without those signals being accessible to the public during, and as a result of that transmission, those distributors then sending those signals to their respective subscribers so that they may watch those programmes...” The crucial element of this decision was the conclusion of the Court that the transmission of the programme carrying signals from the broadcasting organisation only to “specified individual distributors without potential viewers being able to have access to those signals”, namely to three mutually unrelated distributors, “by satellite, cable or xDSL line, and, therefore, by different technical means or processes” does not include the public, since „the term “public” refers to an indeterminate number of recipients, potential television viewers, and implies, moreover, a fairly large number of persons“. The economic implication of this judgement tackled the whole copyright community and denied many millions of Euros of remunerations claimed by the right owners in the musical and audiovisual sector all across the European Union.

### **4.3. Problem of “intermediaries” and “safe harbours”**

Another very complex problem for copyright and related rights in the digital environment, which is directly connected with the communication the public over the Internet and the related remunerations, is the phenomenon of “intermediaries”. In the evolving process of exploitation of protected content on the Internet, specific subjects turned out to be of utmost importance in the transmission of protected content from the right owner to the end user. Besides creative and cultural content, those intermediaries also participate in other transmissions of all kinds of intangible materials and information from the source of the material or information to the consumer of this material and information. Sometimes those intermediaries provide purely technical support in the process of transmission of the protected content, but sometimes their role is much more than purely technical. In relation to the creative and cultural content protected by copyright, the level of active participation of the intermediary in this transmission chain between the source of the content – the right owner – and the end – the consumer of the content – is particularly important. The relation of the intermediary towards the copyright will be decided depending on the level, intensity and extent of the activity of the intermediary, namely whether the intermediary performs the communication to the public or is providing the pure technical support in transmission between the source of the protected content and the end user. This evaluation of the role of the intermediary may have tremendous economic consequence for the right owners. If the intermediary’s role is purely technical, the intermediary will not be responsible for communicating with the public and will not be obliged to pay the remuneration to the right owner. This was the situation in the SBS case. On the contrary, if the intermediary plays an active role in relation to the creative and cultural content, their activity will be determined as the communication to the public and will result in liability for the payment of the remuneration. When taking into consideration the mass amount of creative and cultural content transmitted and distributed via the Internet, the economic consequences of the evaluation of the level, intensity and extent of the intermediary towards the creative content are dramatic.

The intermediaries in the Internet transmissions who operate the platforms where the users upload content (such as You Tube) tend to very successfully show that their role is pure technical by relying on the legal solutions provided for in Articles 12 to 15 of the Directive 2000/31/EC on the electronic commerce, which are called “safe harbour” provisions. The most used article as the defence on the side of the platforms is the

Article 14 of the e-Commerce Directive. Those provisions introduced the “notice and take-down” rule according to which the intermediary, in this case the information society service provider, shall not be considered liable for copyright infringement if they did not know about the infringement and if it, once they were informed on the infringement by the right holder, acted expeditiously by removing the infringing content from their site. During the last 18 years, this legal figure has tremendously affected the value of creative and cultural content on the digital market and consequently the earnings on the side of the copyright owners. At the same time, the business model of platforms ensures them tremendous amounts of money coming from advertising, which was not the intention when the e-Commerce Directive was enacted in 2000. E.g. Weatherlay (2015, 6.1.) claims that “the scope of the E-Commerce Directive today is much broader than was envisaged at the time by those drafting it.” The copyright owners in particular emphasise that the emerging development of the European Single Digital Market and the new business models of exploitation of cultural and creative products brought about the so-called value gap. This is the gap in commercial value that gain online digital platforms which are intermediaries between the creators and the users of cultural and creative content and the commercial value which gain the creators, namely the cultural and creative industries. E.g. IFPI emphasises: “The sustainable and balanced growth of the digital content market continues to be undermined by a fundamental flaw in legislation underpinning the market that has created a ‘value gap’, a mismatch between the value that online user upload services, such as YouTube, extract from music and the revenue returned to the music community.” IFPI claims that inconsistent applications of online liability laws have emboldened certain digital platforms to claim that they are not liable for the music they make available to the public. Liebowitz (2017, p. 35) claims that the reduced copyright payments caused by the safe harbour would appear to be very substantial.

#### **4.4. Choice of law on the Internet**

There is one more very complex issue that affects the exploitation and monetisation of creative and cultural content on the Internet. Since the exclusive rights remained territorial, the problem of private international rules for copyright enforcement in the digital environment remained unsettled until today. This means that the law of the country of protection remains as the main rule connected with the principle of territoriality. (Xalabarder, 2002, Matanovac Vučković, Gliha, 2009, pp. 73 - 76). In the Internet environment, where one upload can be seen and used literally worldwide, the problem with this rule is that it leads to the application of as many legal orders and



laws as there are countries that apply them. In the European Union, this means that 28 different laws should be applied in one case of infringement if the law of the country of protection would apply, with territorial effect of the judgement of the respective competent courts. Jurisdiction is another issue connected with this problem, which raises the problem of economy of the court procedures. Namely, since there are no special rules on the jurisdiction for copyright infringements, general rules should apply. EUCJ accepted the “access approach” in the Pickney case (Matulionyte, 2015, p. 137) where the courts are entitled to issue the judgement in respect of the territory of their respective states (Matulionyte, 2015, p. 137). At the same time, the applicable law is generally the one applicable in the country of protection (*lex loci protectionis*). So far, this rule has had no competitor. Academics are making suggestions for special rules on ubiquitous infringements (Matulionyte, 2015, pp. 140 – 142, Trimble, 2015, p. 403) but there is no bounding instrument that would give undisputable and incontestable rule on the law that should be applied with imminent effect wider than the territory of the state where the enforcement case would take place and beyond the territory of the country of protection. Nevertheless, currently there is no political will to address this problem in the context of Copyright Reform or in any other context on the European level (Torremans, 2016, p.715).

## 5. COPYRIGHT REFORM

The European Union is currently implementing the Copyright reform, a set of legal instruments that should settle the most problematic issues of the copyright protection in the Digital Single Market. These are the Directive (EU) 2017/1564 and the Regulation (EU) 2017/1563, which were passed to implement the WIPO Marrakesh Treaty to Facilitate Access to Published Works for Persons Who Are Blind, Visually Impaired or Otherwise Print Disabled of 2013, as well as the Regulation (EU) 2017/1128 on cross-border portability of online content services. They are already in force and the Member States are implementing them in their national legal orders.

### 5.1. Marrakesh Treaty and Portability Regulation

At the moment, many of the Member States, such as Croatia, are passing the amendments to their national copyright laws in order to implement the Directive (EU) 2017/1564 and the Regulation (EU) 2017/1563. The process is developing smoothly. Even though there have been some problems in the implementation of the Portability

Regulation since some of the addressees tend to circumvent the rules of the respective Regulation and the Member States are currently designating competent authorities or regulators which should facilitate the implementation of the Portability Regulation (European Commission, Letter, 2018) on the national level, the said legal instruments did not cause important disturbances and did not draw particular attention of the expert public or the general public.

## **5.2. Proposal of the Directive on copyright in the Digital Single Market**

Quite opposite to the Directive and Regulation for the implementation of the Marrakesh Treaty and the Portability Regulation, the Proposal of the Directive on copyright in the Digital Single Market turned out to be the prime political issue, since its important part, in particular Articles 11 and 13, was designed essentially with the aim to redistribute the economic benefits derived from the exploitation of the creative and cultural content. The benefit should not remain solely in the hands of the technological giants that operate on the business model based on uploading the users' creative and cultural content. The fair and proportionate part of this benefit should go to the hands of copyright owners – the cultural and creative sector. Briefly, Article 13 was created to bridge the value gap. Since the final text of the Directive on copyright in the Digital Single Market is yet to be born, it will not be discussed here in detail. Nevertheless, all of the present texts of the Council, of the Parliament and of the Commission contain the introduction of the responsibility of the platforms that offer services to the users to upload content, *i.e.* online content sharing service providers (General Secretariat of the Council of the European Union, 2018). According to the Directive, those platforms should be obliged to conclude licensing agreements with the right owners and to pay a fair remuneration. They should no longer benefit from the safe harbour provisions regulated in the e-Commerce Directive. One of the key provisions from Article 13 regulates what happens in case there is no licensing agreement. In this case, the platforms should introduce some kind of technological filters that would prevent the availability of the specific unauthorized creative and cultural content on their services. This provision raised many concerns among tech giants, such as Google, and the general public. The tech giants used social networks and other digital communication channels to spread fear about this provision claiming that it shall stop the freedom of the Internet and introduce censorship and cause many other negative consequences (Reda, 2018). However, this cannot be read from the existing three texts of the Commission, of the Parliament and of the Council (General Secretariat of the Council of the European Union, 2018).

Article 11 of the proposal of the Directive on copyright in the Digital Single Market, which also raised many controversies, should introduce the new related right for press publishers with the aim to force news aggregators, media monitoring services and similar information society service providers to pay the fair and proportionate part of the commercial benefits deriving from their advertisement income to press publishers, which would share this income with the journalists and newspapers photographers.

### **5.3. SatCab Regulation**

The last document on the table in European institutions, which is also a part of the ongoing Copyright reform, is the Proposal for Regulation of the European Parliament and of the Council, which lays down the rules for the exercise of copyright and related rights applicable to certain online transmissions of broadcasting and retransmission of television or radio programmes, the so called SatCab Regulation. It regulates the problem of catch-up online services, the problem of retransmission, and the problem of direct injection which was described above. The said Regulation should influence the definition and understanding of the right of communication to the public since, according to the present texts, the “process of delivering a broadcaster’s programme via signal distributors should constitute one single act of communication to the public by two parties, both of which need authorisation from the relevant right holders for their respective contributions.” (Council of the European Union, Presidency, 2018, p. 3). It was envisaged that the principle of the country of origin would apply to the issue of online transmissions and retransmission, but the scope of the application of this principle was recently reduced to “news and current affairs and to broadcasters’ own productions, thus excluding third party productions controlled by the broadcaster.” (Council of the European Union, Presidency, 2018, p. 2) and due to that it seems that the present text shall only partly overcome the principle of territoriality. Based on the latest developments in the trilogue, it also seems that this instrument shall probably change its nature as it changes from regulation to a directive.

## **6. CONCLUSION**

It seems that the Copyright reform in the European Union aims to foster the economic benefits from the exploitation of creative and cultural content in favour of the right owners and to give a more competitive position for further development of creative and cultural industries in the online market. The studies on the economic value of

creative and cultural industries or copyright-based industries already show that those industries have a significant economic impact. At the same time, some other studies showed that the value gap in online exploitation of creative and cultural content tremendously endangers the future of cultural and media diversity. Therefore, a well-balanced copyright legal framework for better online exploitation of creative and cultural content is an unavoidable condition for its optimal commercialisation and monetisation in the digital environment. Since the copyright reform is still in the development phase, its effects shall be assessed in the future. If the Copyright reform offers proper solutions to online challenges, it is to be expected that the future studies on economic value of creative and cultural industries shall show its significant growth.

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## **COMPETITIVENESS TODAY: IS CROATIA ADDRESSING ONGOING GLOBAL CHALLENGES?**

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### **SUMMARY**

*Competitiveness has been a key term for decision makers around the globe for achieving economic growth and prosperity since the 1990s and Porter's pioneering work "The Competitive Advantage of Nations". Although criticized for being a flashy synonym for productivity and other methodological shortcomings, Porter's theoretical framework became a base for competitiveness projects and reform implementation in many countries. Croatia joined the Competitiveness Initiative at the beginning of the new millennium, establishing the National Competitiveness Council and incorporating Croatia in the global competitiveness benchmarks of both IMD World Competitiveness Centre and WEF Global Competitiveness Programme. Among other relevant issues, this paper explores key determinants and pillars of Croatia's competitiveness. Based on the analysis of secondary data and a case study, this work aims to serve two purposes. First, it is to disentangle the effects of the Croatian competitiveness project and second, to research the extent to which Croatia is addressing contemporary global competitiveness agenda.*

### **1. INTRODUCTION**

Competitiveness at the national level represents the ability of a nation to endorse such policies and measures that support economic growth and sustainable development and lead to a high standard of living in a long term. The concept and methodology of national competitiveness are credited to Michael Porter and his work has been well recognised as well as contested by academia in around three decades of academic debate. This process only raised the popularity of the concept of competitiveness, which remained a key term for politicians and other decision makers around the world

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when setting the agenda for economic growth and development of their home countries.

Competitiveness of different nations has been analysed in two leading reports, namely the Global Competitiveness Report published by the World Economic Forum and the World Competitiveness Yearbook published by the IMD World Competitiveness Centre. Different competitiveness initiatives have been established in many countries worldwide with an ambition to analyse and determine key areas in which a certain country needs to focus its policies and institutional support in order to promote economic growth and productivity. Croatia has also joined the competitiveness programme and established the National Competitiveness Council, which brought together high representatives of government, the private sector, academia and trade unions, in order to reach consensus on key areas for actions to improve Croatia's competitiveness position. In early 2000, Croatia has joined both competitiveness benchmarking reports which resulted in a more precise understanding of Croatia's competitiveness position in the world as well as among its partnering countries.

The purpose of this paper is twofold, firstly, to examine the effects of the competitiveness project in Croatia and secondly, to research the extent to which Croatia is addressing current global competitiveness challenges. The methodology used in this paper to reach these goals includes an analysis of secondary data and a case study.

The paper proceeds as follows: chapter two provides an overview of competitiveness theory and Porter's diamond model as well as literature review of academic debate on theory and econometrics of competitiveness. Chapter three looks deeper into competitiveness initiatives on the national level and measuring competitiveness on the case study of Croatia, chapter four discusses the degree level and depth to which Croatia is addressing the ongoing global challenges while chapter five summarises main ideas and concludes.

## **2. LITERATURE REVIEW**

Competitiveness has been a part of academic debate for around three decades and consequently, it has numerous definitions. Although rich in theory and/or criticism, the early works of Porter (1990) and Krugman (1994) do not give a clear and precise definition of competitiveness. While at opposite poles, both Porter and Krugman link

“amorphous notion of competitiveness” (Porter, 1990, p. 6) closely to the level of national productivity and international trade capability. Later works define competitiveness as: “the set of institutions and economic policies supportive of high rates of economic growth in the medium term” (Porter, Sachs, Warner, 2000, p. 14). Definitions from other international institutions put emphasis on a high and rising living standard and employment on a sustainable basis (European Commission, 2003, p. 6), while the Organisation for Economic Co-operation and Development (OECD, 2017) focuses somewhat more on international trade. Therefore, their statistical analysis concentrates on two measures of competitiveness: domestic and foreign labour cost per unit in manufacturing and consumer prices.

From the 1990s, competitiveness has been a key term for decision makers around the globe for achieving economic growth and prosperity. It started with Michael Porter’s pioneering work “The Competitive Advantage of Nations” (1990). In the area of national competitiveness, Porter explored macroeconomic topics using microeconomic lenses. Porter’s research (1980, 1985) and published papers in the 1980s dealt with strategic management, focusing on different industry structures and companies’ strategies for gaining and retaining business success and market leadership through the new theoretic concept of the value chain. In 1990, Porter used his area of expertise – strategic management and competitive advantage of a firm as a tool to examine broader areas, such as economic development and international trade. Through series of comparative case studies across nations and sectors, Porter analysed competitiveness of nations and seek to identify patterns of success and key factors that can contribute to better economic growth and sustainable development of different nations.

Porter argued that is it not enough to investigate “Why do some nations succeed and others fail in international competition?”, but instead, he re-direct the question: “Why does the nation become the home base for successful international competitors in an industry? Or to put it somewhat differently why are firms based in a particular nation able to create and sustain competitive advantage against the world’s best competitors in a particular field?” (Porter, 1990, p. 1). He has conducted in-depth comparative case studies of different industries in ten developed countries<sup>1</sup>, examining their source of national competitiveness. Porter argued that fundamentals of nation’s competitiveness do not (at least not in the long term) rest in policies such as favourable exchange rates, large positive balance of trade or low labour costs. In his comparative case study

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<sup>1</sup> United States, Germany, Italy, United Kingdom, Denmark, Sweden, Switzerland, Japan, Korea and Singapore.

research, he was determined to identify patterns for countries' abilities to create a sustainable economic model, which supports economic growth, outstanding position on international markets, high wages and consequently high living standard (Porter, 1990, p.179-573).

Porter built an explanatory theory of competitive advantage of nations, also known as "Porter's diamond". He identified determinants of national advantage, i.e. factors that contribute to success in particular industries. These four factors include: (i) factor conditions – quality and quantity of: labour, capital and infrastructure, (ii) demand conditions – size and level of home demand for products and services (sophisticated and demanding buyers at the home market), (iii) related and supporting industries – the significance of their existence or non-existence at the market, and (iv) firm strategy, structure and rivalry – the level of companies' productivity, innovation and competition at the domestic and international level. He also added two additional variables: chance - developments independently of the firm's influence (technological inventions, political developments, etc.) and government policies (Porter, 1990, p. 69-139).

Michael Porter's work on national competitiveness raised much criticism for its methodology, macroeconomic theory and inventiveness. The most prominent opponent of the competitiveness paradigm is economist Paul Krugman (1994, 1996). He criticised the rhetoric of competitiveness for its lack of originality and for occasionally being wrong. Primarily, Krugman sees nothing new in the "magical" term competitiveness. For him, it is just "a poetic way of saying productivity" (Krugman, 1994, p. 35). He finds that competitiveness is just a new trendy expression used by politicians to initiate certain economic policies that will hopefully boost economic growth and development (e.g. Jacques Delors in the EU and Bill Clinton in the US, *ibid*, p. 28-29). Furthermore, he warns that competitiveness is often misused by the political establishment by turning the focus off the real economic issues and problems (e.g. unemployment, slow growth rates), which he argues is manipulative and misleading. It should also be noted that Porter stresses productivity as a key determinant of nation's growth and standard of living: "The only meaningful concept of competitiveness at the national level is national productivity" (Porter, 1990, p. 6).

Krugman is rather rigorous in his evaluation of economists for choosing the conventional wisdom to make arguments policy options instead of focusing on scientific approach and rigorous economic analysis of statistical data. In his opinion, some economists did not provide data analysis to support their arguments; in fact, he

finds their statistical data analyses are in some cases even contradictory to the hypothesis they are arguing for (e.g. Thurow, in Krugman, 1994, p. 35-39). Finally, Krugman believes this type of public rhetoric is actually dangerous because it advocates competition between different countries, putting them in a position of rivals instead of partners, which can also result in some undesirable side effects (e.g. more protectionism, trade wars).

There is a considerable amount of research papers disapproving of Porter's model and methodology (Thurow, 1990; Bellak, Weiss, 1993, Dunning 1992, Gray 1991, Jacobs, De Jong 1992 in Psafogiorgos, Metaxas, 2015; Grant 1991). For example, Kaufman, Gittell, Merenda, Naumes and Wood (1994, p. 45) find affiliation between connected entities in a complex set of variables rather questionable, while Grant (1991, p. 541-542) alerts to the lack of clarity of factors contributing to international competitiveness, i.e. direct investment and competitive advantage build upon exports. Examining Krugman's work, Ketels (2016, p. 7-8) differentiates views on competitiveness between focusing the analysis on unit labour costs and consequently the ability to export versus the productivity-based view of competitiveness. Numerous other studies and different approaches have all led to a more complex and profound assessment of the competitiveness of nations, which is still considered to be one of the most discussed and relevant benchmarks for comparing different countries and their economies. For decades, the most prominent institutes, the International Institute for Management Development (IMD), the World Economic Forum (WEF) with the Harvard University, have been publishing global competitiveness reports, comparing and discussing countries' strengths and weaknesses, which will, along with other studies (e.g. the World Bank Doing Business Report) be discussed in more details in this paper.

In summary, although criticised by many economists for shortcomings in macroeconomic theory models or lack of originality, Porter remains one of the most influential business economists of the present time as his theoretical framework became a base for competitiveness projects and reform implementation in many countries, often supported by the highest level of government and business stakeholders. Unlike institutions such as the International Monetary Fund, it is hard to find Porter's opponents stating that his method did harm particular nation's economy.

### 3. NATIONAL COMPETITIVENESS INITIATIVES AND MEASURING COMPETITIVENESS IN CROATIA

Benchmarking Croatia through the Global Competitiveness map allows us to obtain an objective view of where Croatia is in comparison to its neighbouring countries or major trading partner countries and to identify its strengths and weaknesses. Those weaknesses can be addressed in order to improve the relative competitiveness of Croatia and to boost the economic recovery and narrow the gap with the average development of comparable CEE countries. In 2008, Croatia stood at 63% of development of the EU28 average (measured by GDP p/c, Table 1), while four of the EU10 countries were at the lower level of development than Croatia (Latvia at 60%, Poland at 54%, Romania at 48% and Bulgaria at 45% of the EU average), and two were at the same level with Croatia, namely Lithuania and Hungary (Eurostat, 2017).

Table 1

*GDP per capita in PPS, Index (EU28 = 100)*

Country	2008	2016
Slovenia	89	83
Czech Republic	84	88
Slovakia	71	77
Estonia	68	74
Croatia	63	59
Lithuania	63	75
Hungary	63	67
Latvia	60	65
Poland	54	69
Romania	48	59
Bulgaria	45	48

Source: Eurostat, <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00114&plugin=1>; Date of access: September 29<sup>th</sup> 2017.

According to the Eurostat data (2017), in 2015, Croatia was at 58% of the development of the EU average, while Romania grew to 58% and Bulgaria to 46%. In 2016, Croatia slightly improved its position, reaching 59% of EU average, but Romania also improved its position, reaching 59% of the EU average, while Bulgaria rose to 48% of the EU average. Croatia's decline during the 2009-2014 period should be attributed to the economic downturn. Namely, Croatia recorded a period of economic decline in the period of 2009-2014, during which the real GDP fell by more than 12%. Economic recovery started in 2015, continued in 2016 and in 2017 (ibid.)

Gradual economic decline in Croatia was under the influence of the slowdown and negative growth of the EU economy. Namely, in 2009, the EU economy fell by 4.3% (European Commission, 2017) with a spillover effect on the Croatian economy. Croatia's main trade partners recorded an economic downturn, which had a negative impact on Croatia's export of goods, especially prior to Croatia becoming an EU member state. Structural weaknesses in Croatia's economy, delay in structural reforms, high dependence on tourism as a source of foreign currency (and weak links between the tourism sector and the food processing industry), negative demographic trends in the country, high emigration, low investments in R&D which would improve competitiveness, slow adjustment of the economy to the global trends and needs, insufficient links between the educational system and market needs... had a negative impact on the competitiveness of Croatia's economy (ibid.).

As a consequence of the economic downturn, Croatia started to lag behind the EU average. In that context, it is crucial to stress that in 2009 almost all EU countries recorded a sharp GDP decline, which at the EU average reached 4.3%, while some EU countries (Baltic states) recorded more than 10% drop in real GDP. Croatia was among those countries with a sharp GDP decline, which reached 7.4% in 2009 (Eurostat, 2017).

In the following year (2010), almost all countries in Central and Eastern Europe recorded economic recovery, which continued in the following year. By 2016, almost all Central and Eastern European countries reached pre-crisis levels of GDP (only Slovenia and Croatia did not reach the 2008 GDP levels). While Slovenia almost reached the 2008 level, Croatia's real GDP stood at -8.4% compared to 2008. Since the EU economy recorded GDP growth in the 2009-2016 period (with the exception of 2009 and 2012), EU GDP per capita in PPS was rising. As a consequence of the economic decline in Croatia (and Slovenia) and a rise of GDP per capita on the EU level, Croatia (and Slovenia) recorded a decline compared to the EU average level of development (Table 1).

In 2016, economic growth in Croatia stood at 2.9% (European Commission, 2017a, p. 2). It is important to stress that the GDP growth was based on the growth of all demand categories. However, it should be emphasised that in 2016, growth was still at a low basis, i.e. low economic activity levels, 8.4% lower than in 2008, and that it was achieved under the described favourable external conditions, mostly with a still relatively low price of crude oil and other energy and that it was not considerably more dynamic relative to other EU countries or relative to the EU10 members.

Therefore, the success of the recovery and economic policy can be measured only by the acceleration of growth rates in this and subsequent years, i.e. predominantly based on the accelerated growth rate of the exports of goods. In this regard, i.e. the acceleration of goods' exports, relative (non)competitiveness of Croatia should be considered because it is a limiting factor to faster and stronger exports, including overall economic growth.

In that context, it should be noted that at the beginning of 2017, economic growth continued in Q1, although at a slightly lower pace (2.5%). The greatest contribution came from the exports of goods. Still, the foreign demand contribution was negative. This is a consequence of relatively strong imports, which grew as domestic demand and the export of services grew due to high dependence on imports. High rates of growth in the European market, as well as the fact that more and more Croatian companies are turning towards the foreign market, creates further possibilities of export to those countries. Still, only about 15% of the Croatian companies are exporters. Those companies employ 52% of total employees in Croatian companies (Central State Portal, 2017).

Increased income from exports on their balance sheets reduces dependence on the relatively small Croatian market, spurs faster transfer of new technologies and new knowledge and diminishes the vulnerability of the economy. Consequently, that enables the opening of new jobs. Expectations that the EU economies (Croatia's main trade partners) will continue to register stronger demand during this year, will lead to the continuation of growth in Croatia's exports in goods. On the other side, the exports of services (tourism) and stronger domestic demand will generate a rise in imports.

Part of the answer to why Croatia is lagging behind the EU10 countries can be explained after analysing the indicators of the Croatian competitiveness ranking provided by World Economic Forum. The position of GCI for Croatia shows the space in which Croatia is moving relative to the other countries of the world according to the above index. From 2009 until the present, Croatia had the best position in the 2009 – 2010 report when it was the 72<sup>nd</sup> out of 133 countries. The least favourable position according to the GCI was the 81<sup>st</sup> position of the 144 observed countries in the 2012 – 2013 Report (Table 2).



Table 2

Competitiveness position of Croatia's economy, 2009 – 2016

World Economic Forum - GLOBAL COMPETITIVENESS INDEX (GCI)	Among % best performing in the world, 2009 – 2016
Overall GCI for Croatia	51% – 56%
PILLARS OF GCI	Among % best performing in the world, 2009 – 2016
Institutions	60% – 68%
Infrastructure	27% – 37%
Macroeconomic environment	37% – 76%
Health and primary education	33% – 48%
Higher education and training	34% – 42%
Goods market efficiency	69% – 80%
Labour market efficiency	69% – 82%
Financial market development	51% – 69%
Technological readiness	27% – 35%
Market size	49% – 57%
Business sophistication	58% – 67%
Innovation	46% – 75%

Source: World Economic Forum. (2016) The Global Competitiveness Report 2016 – 2017, author's calculation.

If the relative position of Croatia was calculated in all of the observed years (since the number of countries covered by the index calculation varies from year to year and ranges from 133 in 2009 to 148 in 2013), the following can be concluded: Croatia's position of the GCI in the 2009 – 2016 period ranged between the first 51% to 56% of the countries, i.e. it held a rather static position in the past eight reports of the World Economic Forum. Croatia's static position in GCI reports (Table 2) can be attributed to several factors. It is visible that a number of sub-indicators (pillars) of the GCI are stagnating over time, i.e. relative position of Croatia remains almost unchanged. That refers primarily to indicators (pillars) such as: institutions (oscillations from 60%-68%, i.e. 8 basis points), infrastructure (oscillations from 27%-37%, i.e. 10 basis points), higher education and training (oscillations from 34%-42%, i.e. 8 basis points), labor market efficiency (oscillations from 69%-82%, i.e. 13 basis points), technological readiness (oscillations from 27%-35%, i.e. 8 basis points), market size (oscillations from 49%-57%, i.e. 8 basis points) and business sophistication (oscillations from 58%-67%, i.e. 9 basis points).

Several other sub-indicators (pillars) of the GCI create a pressure on downward movements: macroeconomic environment, health and primary education, innovation.

A few sub-indicators (pillars) of the GCI which have a positive trend or oscillations during the 2009-2016 period (goods market efficiency and financial market developments) are not enough to create a strong positive influence on the upward movement of the GCI (Table 3). Therefore, the core issue of improving the CGI for Croatia is to mobilize resources, which would enable Croatia to gradually record an upward trend of GCI position. It primarily refers to those sub-indices (pillars) of the GCI, which have stagnated in the 2009-2016 period and recorded very narrow movements.

Table 3

*Global Competitiveness Index, trends in Croatia, 2009-2016.*

World Economic Forum - GLOBAL COMPETITIVENESS INDEX (GCI)	Trend 2009 --> 2016
Overall GCI for Croatia	stagnation
<b>PILLARS OF GCI</b>	<b>Trend 2009 --&gt; 2016</b>
Institutions	stagnation
Infrastructure	stagnation
Macroeconomic environment	deterioration
Health and primary education	deterioration
Higher education and training	stagnation
Goods market efficiency	slight improvement
Labour market efficiency	stagnation
Financial market development	oscillations
Technological readiness	stagnation
Market size	stagnation
Business sophistication	stagnation
Innovation	deterioration

Source: World Economic Forum. (2016) The Global Competitiveness Report 2016 – 2017, author's calculation.

Croatia's unfavourable situation in GCI in the last few years can be explained by the poor structure of the Croatian economy. It can also be argued that the economic policy-makers have not adjusted to the market trends in order for the situation to change significantly. Moreover, the structure of the economy is not adequate, i.e. it is not sufficiently adjusted to the market and external demand. It is worth noting that Croatia has very small goods exports relative to the size of the economy - the value of the exports of goods to GDP ratio stands at about 27% in Croatia, which is the lowest among all of the EU10 countries and half the average of this group of countries.

In addition, in recent years Croatia was lacking an economic growth model, which would take into account Croatian competitive advantages and enable long-term sustainable GDP growth. Individual periods, marked by dynamic growth, were primarily attributed to the previous low level of economic activity, long-term unsustainable growth factors (a considerable increase in internal and external debt). This is especially shown when Croatia is compared with peer countries, i.e. Central and East European countries, which have recorded higher growth rates of their economies (European Commission, 2017, p. 1).

In addition, GDP movements suggest the need for further improvement in economic policy. The current expectations on further GDP growth result again from forecasts of further growth of the value of goods and services. Those expectations rely on another good tourist season, increased personal consumption facilitated by the latest amendments to the income tax system, the increase in wages in public services, the growth of pensions, further recovery of credit activity and growth of investment (to a great extent connected with a better absorption of EU funds). However, these are mostly not the sources of growth, which by themselves ensure a long-term acceptable growth model. Therefore, it is necessary to concentrate on finding the model which would boost investment in production and increase the value of the exports of goods. Despite falling behind the majority of indicators, the difference in the dynamics of goods export growth stands out as the key in Croatia's long-term lagging behind other peer countries of Central and Eastern Europe. The strengthening of competitiveness of Croatian economy, and indirectly the competitiveness of Croatian goods and services in foreign markets, would affect the improvement of Croatia's position.

Doing Business ranking of the World Bank can give an additional clarification of Croatia's unfavourable competitiveness position, in part of regulatory aspects (Table 4). In Doing Business Report 2009-2017, Croatia was the worst ranked country during the entire observed period in the CEE countries (World Bank, 2009-2017). The only exception was the 2016 report, when Hungary was ranked one position below Croatia.

Table 4

Croatia's Position in Doing Business Reports

Doing Business Report (DBR)	Number of countries in DB Report	Croatia's Position	Croatia among % best performing in the world
<b>1</b>	<b>2</b>	<b>3</b>	<b>4=3/2</b>
DBR 2017	190	43	23%
DBR 2016	189	39	21%
DBR 2015	189	65	34%
DBR 2014	189	89	47%
DBR 2013	185	84	45%
DBR 2012	183	80	44%
DBR 2011	183	84	46%
DBR 2010	183	103	56%
DBR 2009	181	106	59%

Source: The World Bank. (2009-2017). *Doing Business Reports*, author's calculation.

According to the ease of Doing Business index from 2009 to 2014, Croatia positioned itself in the range of the first 47% to 59% of the countries. This means that Croatia held a rather static position during the six years period, in particular between 2011 and 2014, ranging from 44% to 47% (Table 4). That narrow range suggests that Croatia was almost "fixed" in relative movements for a number of years, which negatively affected the economy. Namely, no significant impetus was created to stimulate economic growth, because reforms were constantly delayed. Still, the need for improvements remain in order for the system to become more efficient and competitive.

It should also be noted that during the past two years the gap between the Croatian ranking and the ranking of the EU10 narrowed considerably. However, the trend of convergence with the EU10 did not remain steady in the 2017 report, since the difference increased from the previous report. It was a consequence of a lower rating - Croatia's score fell back to the position of the worst ranked country among the EU10 countries. In the context of the Doing Business index, starting a business and dealing with construction permits in Croatia are emphasised as the areas that are constantly among the worst ones and the most remote from the EU10 average. This refers to the areas that are most connected to public administration efficiency, which is repeatedly mentioned in the context of obstacles for a higher and better inflow of foreign investment, in particular in the exports sector (internationally traded goods).

In relation to Croatia's relative non-competitiveness, it might be concluded that since the beginning of the economic crisis, i.e. since 2009, Croatia has been "trapped" in the

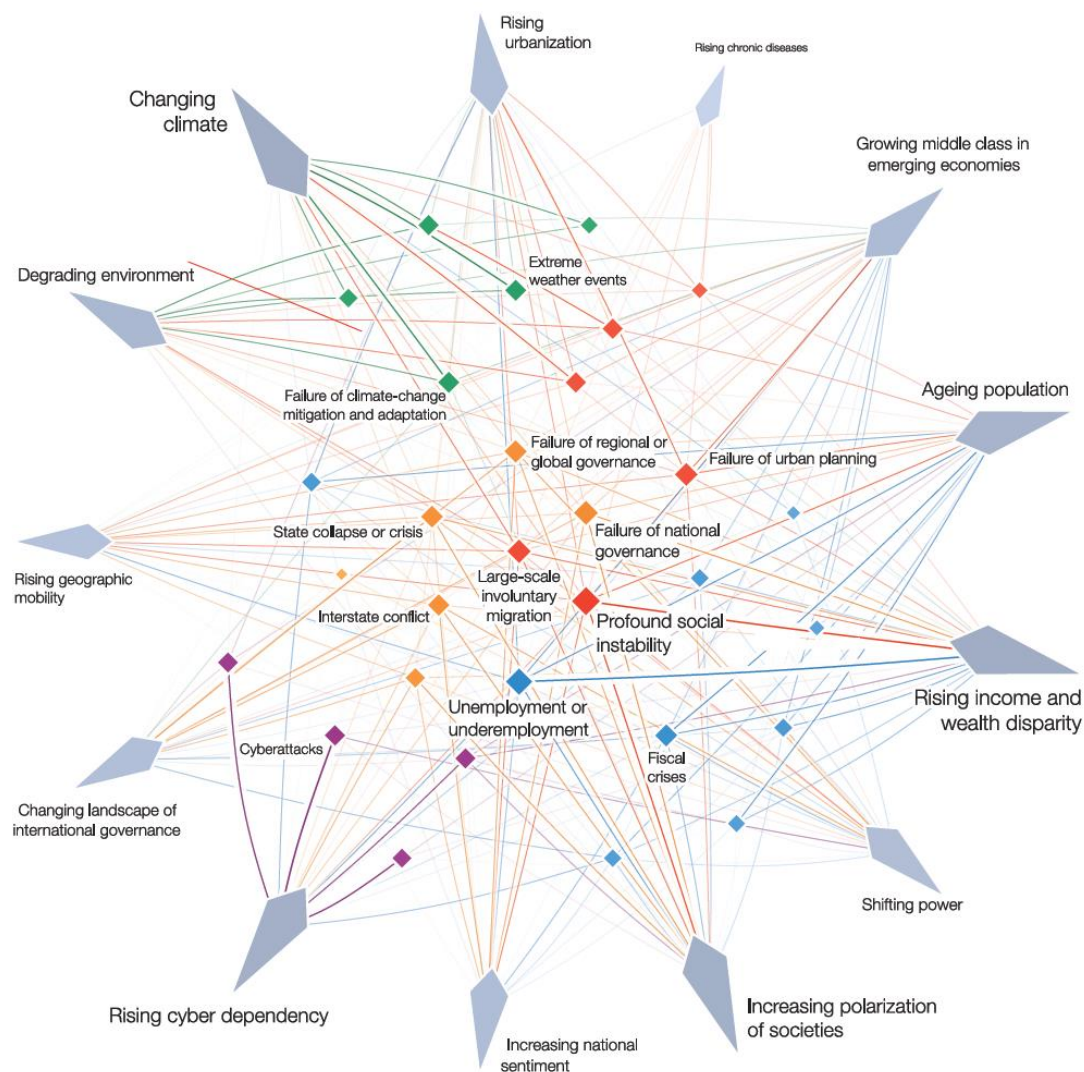
condition of relative non-competitiveness compared to the CEE countries. Moreover, according to numerous competitiveness indicators, Croatia has been stagnating in the observed period, almost without any positive improvements through time in global competitiveness rankings. For this reason, Croatia is in a need of systemic reform, which should have a positive impact on gradual improvements in the competitiveness index and ease of doing business rankings. Improvements in the global rankings can redirect Croatia from the condition of a static economy to the economy that should gradually move towards and beyond the average levels of competitiveness of CEE countries, attract investment, boost exports, and thereby affect the incentives to economic growth.

#### **4. IS CROATIA ADDRESSING ONGOING GLOBAL CHALLENGES?**

The 2007-08 global financial crisis started as a crisis in the subprime mortgage market in the USA, spilt over into the international banking crisis and grown into full-scale global financial and real sector crisis leaving no part of world economy untouched. Global political decision makers pushed forward for a new set of regulation and supervision. In the US, new financial regulation is implemented through a single act, the Dodd-Frank Act. The EU opted for a set of legislations with the establishment of new European supervisory authorities. Global financial crisis consequently led to the Eurozone crisis (Ferran, Moloney, Hill and Coffee, 2012). The new EU policy response includes the creation of the European Banking Union and the Capital Markets Union; however, implementation of a new financial framework will be a long-term project, which will most likely include adjustments along the way due to a high level of uncertainty in both political and economic arena (European Commission, 2010).

Consequences of the 2007-08 global financial crisis are still very much present on the macroeconomic level through incessant slow growth and financial markets fragility, including the perpetually high debt level in emerging markets. Although world governments are taking actions to endorse growth and economic activity through long-term low-interest rates, there is still a slowdown in investment rates and productivity levels.

Figure 1  
The Risks-Trends Interconnections Map



Source: World Economic Forum (2017) "The Global Risks Report 2017 – 12<sup>th</sup> Edition", p. ii.

The World Economic Forum (WEF, 2017) alerts on series of interlinked risks on a global level that could have a significant negative effect on some regions or industries over the next ten years (Figure 1). Income inequality has been identified as one of the most important risk factors. Piketty's study on economic inequality pointed that when income from capital, i.e. rate of return on capital is greater than the economic growth over a longer period, the aftermath will be an unequal distribution of wealth (Piketty, 2014). In other words, faster economic growth diminishes the importance of wealth in a society, while slower growth increases it. Generally, inequality has been decreasing in industrial economies since the 1980s (McCloskey, 2016 and Roser, 2016, n. 4 in World Economic Forum, 2017, p. 19). This trend remains the same for many developed

European economies, e.g. Germany, France, and Scandinavia. However, the significant rise in income level of the top 1% has increased in the US, UK, Canada, Ireland and Australia, while having moderate growth for middle class (World Economic Forum, 2017 p. 11-12). WEF states that in the US, between 2009-12, the income of the top 1% increased over 31% while for the remaining 99% of working population incomes grew by 0,5% (World Economic Forum, 2017a). Saez's analysis shows there had been a noticeable income growth for all groups in the USA between 2013 and 2015. However, he warns that income inequality remains very high (Saez, 2016).

In Croatia, research generally shows that there was an increase in inequality and poverty during and after the 1990s political and economic reforms. Aksentijević, Bogović, Ježić (2006) also point out that poverty in Croatia is mostly determined by the factor of education and employment. Orsini and Ostojić (in European Commission 2015, p. 2-4) noted that before the 2007-08 global financial crisis wages in Croatia were following the upward trend, mostly due to expectations of rapid income convergence. The same trend was noticeable for all Central and Eastern European EU Member States. Following the crisis, the real wages fell, with private sector real-time adjustments and public sector wages alterations lagging behind (*ibid.*, p. 4-8). The analysis of public and private sector wages in Croatia (commissioned by the Ministry of Finance of the Republic of Croatia) shows that average net salary per hour is approximately 25% higher than in the private sector. The analysis also points to the decrease in income inequality in the public sector in the period from 2004 to 2012, while the trend is opposite in the private sector (Nestić, Rubil, Tomić, 2014, p. 1-3, 16-17). From the above-mentioned data, we can conclude that Croatia follows the pattern of Continental Europe of income equality to a certain extent, but the data also indicates that productive and innovative labour is not sufficiently supported through the wage level.

Income inequality, persistent slow growth, extraordinary high debt levels in emerging markets, demography and financial markets' fragility can lead to social and political instabilities. Additionally, the increased polarisation of the global society raises concerns regarding the geopolitical situation. The deglobalisation sentiment has been reflected in the recent elections in the US and the UK – Brexit vote. Populism has proven to be a winning tactic in attracting voters negatively affected by the globalisation process. Unlike the pre-election rhetoric about job losses due to outsourcing, it was estimated that in the USA about 86% of manufacturing job losses between 1997 and 2007 were due to the technological developments and only 14% due

to trade (World Economic Forum, 2017a). However, post-truth politics promote isolation and protectionist measures, with international organizations and cooperation processes being put to reassess. The general perception is that the current state of capitalism does not create positive effects for the society (World Economic Forum, 2017, p. 11-18).

Two more major risk factors need to be discussed – technology and climatology. Schwab describes the Fourth industrial revolution as a complete transformation of the world we live in and the way we live it (Schwab in Sala-I-Martin et al., 2016). “The changes are historic in terms of their size, speed and scope” (ibid., p. 4). Emerging technologies such as artificial intelligence, robotics, energy storage and transmission, 3D printing, bio-, nano- and neurotechnology, etc., should be used to shape the societies in the way that improves the state of the world – our abilities, opportunities, quality of lives, preservation and improvement of climate and natural environment (Schwab, 2016a). Schumpeter’s lesson of creative destruction is warning us that, along with numerous benefits of better products at lower prices and a higher standard of living, managing technological disruption will be challenging in the sense of employment, especially of less educated population and will bring serious social challenges (Schumpeter, 1976, p. 105-111). As Friedman (2016) put it in present time and circumstances: we live in the age of acceleration in which technology, globalisation and climate change provided us with incredible opportunities and threats, therefore we need collaboration as one of the most important categories for future prosperity and peace.

According to data of the Global Competitiveness Report 2016-2017 (World Economic Forum, 2016, p. 371-378) technological readiness (oscillations from 27%-35%, i.e. 8 basis points) can be taken as one of the pillars on which Croatia could build its competitiveness. Namely, that indicator is the best performing among 12 pillars of the GCI (Table 2), since the relative position of Croatia among other world countries varies in the range of 27%-35%. Therefore, that pillar stands out as the best performing among other pillars for Croatia. Moreover, that pillar has the potential for improvement, since it is related to the adoption and availability of latest technologies.

World Economic Forum (2017, p. 16) warns of the spiral of environmental-related risks: extreme weather events, climate change and water crises, which can further accelerate geopolitical risks. In order to present some statistics, the United Nations Environment Programme (UNEP, 2011) stated that nine out of the last ten years were the hottest on record. The United Nations High Commissioner for Refugees (UNHCR,



2016) estimated that between 2008 and 2015, there were, on average, 21.5 million people displaced each year due to extreme weather events, and the United Nations Office for Disaster Risk Reduction (UNISDR, in World Economic Forum, 2017, p. 17) stated that close to 1 billion people experienced distress due to natural disasters in 2015... All of these data, along with many other disturbing news warn us about climate rapidly changing and the necessity to take action and collaboration on the global level. The Paris Agreement is a UN Convention on climate change, discussed and adopted between 197 parties to the Convention, and it represents global agreement on goals and measures needed to be achieved in order to sustainably manage global warming. Up to date, 168 countries have ratified the Paris Agreement, which has entered into force in November 2016 (United Nations Framework Convention on Climate Change, 2017).

Croatia ratified the Paris Agreement in 2017 (The Croatian Parliament, Act on adoption of the Paris Agreement, OG 3/17). The United Nations Development Programme (UNDP, 2008) conducted an analysis of climate change and its impacts on Croatian society and economy. The Report finds Croatians to have a high level of awareness about climate change and the importance of appropriate government actions and measures to be implemented in the whole of society (ibid., p. 23-32). The Report estimates that Croatia already suffers economically from climate change; firstly, in human health – due to the higher temperature level during the summer period, there has been an increase in mortality (ibid., p. 91-93). In addition, agricultural production had a downturn in yields of various crops due to extreme weather events, resulting in the annual cost to agriculture of around EUR 176 million, as well as quality downturn (e.g. appearance of invasive fish species, ibid., p. 121-148). Finally, the tourism sector may experience some challenges because of rising temperatures during the summer months, but it could also profit from warmer weather periods during spring and fall, which could prolong the tourist season (ibid., p. 53-70).

## **5. CONCLUSION**

Competitiveness has been an important theme of academic debate and economic policy agendas for many countries across the globe for over three decades now. Pioneer work of Michael Porter on competitiveness and “diamond” model proved to be a very useful methodology to examine a nation’s strengths and weaknesses and determine goals and actions for future economic growth and development. Croatia, like many other countries, joined the competitiveness project at the beginning of 2000,

establishing the National Competitiveness Council that brought together high representatives of government, the private sector, academia and trade unions with a goal to reach consensus and act on important issues for Croatia's competitiveness. The work of the Council included, among others, incorporating Croatia into global competitiveness reports, namely the Global Competitiveness Report by World Economic Forum and the World Competitiveness Yearbook by the IMD World Competitiveness Centre, which both provided decision makers and other stakeholders with objective ranking and comparison of Croatia with other countries in significant economic, political and social areas.

Until 2008, Croatia recorded a solid economic growth, with the level of development very close to the average level of development of EU10 countries. Namely, Croatia was only -2% below the EU10 average. During recession years (2009-2014), Croatia recorded a GDP decline of more than 12%, the sharpest drop compared to other EU10 countries. As a consequence of the economic decline, Croatia started to lag behind the EU average level of development. Namely, after reaching 63% of the development of the EU average in 2008, Croatia fell to 58% in 2015 and recovered slightly to 59% in 2016. In that period, all EU10 countries improved their relative position (with the exception of Slovenia). Namely, EU10 countries did not experience such a long period of recession like Croatia – in 2009, the majority of countries recorded a GDP decline (except Poland, which had a positive GDP growth), but recovered within a short period of time.

Structural weaknesses in Croatia's economy, lack of structural reforms, high dependence on tourism (but with insufficient business links between tourism consumption and domestic production), negative demographic trends in combination with high emigration, low investments in R&D, slow adjustment of the economy to the global trends and needs, insufficient links between the educational system and market needs... contributed to the structural instability of the economy. Relative non-competitiveness and reasons for lagging behind EU10 countries can be explained through the indicators of the Croatian competitiveness ranking provided by the World Economic Forum. Namely, Croatia's position on the Global competitive index in the 2009 – 2016 period ranged between the first 51% to 56% countries, i.e. it held a rather static position. Therefore, the core issue for Croatia is to mobilize resources, which would enable Croatia to gradually record an upward trend referring to the Global competitive index position.

In conclusion, the analysis conducted in this paper points to areas in which Croatia needs to push for further reforms and implement better measures in order to enhance the quality of the microeconomic business environment and increase national competitiveness. Our study also showed that Croatia is generally moving in a positive direction when it comes to current global challenges, such as technology, income equality and climatology, which, although far from perfect, are still more on the side of contributors to stabilization than the opposite, which, considering current global challenges, is a positive indicator for the future.

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