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Articles in social sciences and humanities

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Foreword

"Each end is the beginning of something new!" This quite well-known saying should be kept in mind in regard of the current collection of research articles as well. On the one hand this is the last collection published under the auspices of International University Audentes. Since 30 June, 2009 International University Audentes (IUA) has gone down in history as an independent educational institution or at least an autonomous structural unit of Tallinn University of Technology (TUT) as it had existed since 1 July, 2008. However, the legacy of International University Audentes is still there, the people who have built up the former International University Audentes have found their new positions in different structural units of Tallinn University of Technology and continue their activities including research.

On the basis of former IUA two new structural units with clear identity and sufficient scientific potential have been formed – the Department of International Relations within the TUT School of Economics and Business Administration and Tallinn Law School within TUT Faculty of Social Sciences. The Department of International Relations of Tallinn School of Economics and Business Administration has a clear intention to develop the current edition – The Proceedings of the Institute for European Studies – and upgrade it in order to reach the goal of transforming the edition into an internationally recognized scientific journal in the field of social sciences.

The current collection of peer-reviewed scientific articles aims to represent the best results of the research in the field of social sciences and humanities conducted at International University Audentes during the last couple of years. All of its former academic units (Business School, Law School and the School of Social Sciences and Humanities/School of International Relations) are represented. In addition to that, this collection and also the previous issues of the Proceedings of European Studies have always been open for the contributions from other universities - the closest IUA cooperation partners in the field of research. Moreover, as a matter of fact, some of the papers received as a result of the same call for papers have already been published in the previous issue of the Proceedings of the Institute for European Studies (No. 4) in late 2008. At the same time there are a lot of papers still waiting to be published.

As one can see the scope of the current collection is unexpectedly wide. It addresses such diverse issues as political philosophy, theory of area-studies, EU legislation, economics, human resources management and the development of institutions, the principles of library financing and even film theory. In his article, the Associate Professor James Thurlow has paid special attention to different interpretations of Immanuel Kant's Categorical Imperative. He finds a link between the humanist and the nationalist interpretation of this universally recognized principle worked out by German Nazis in the views of French nationalist socialist Maurice Barrès. Professor Thomas Pedersen from Denmark deals with the problems of inter-relations between empirical area-studies and general theory often confronted in EU studies. He believes that the conceptualization of the area-studies

might contribute to the development of general, explanatory theory, on such complex issues as i.e. the European Union and its different theoretical models of integration.

Several papers in this collection are dedicated to legal issues. In his paper the PhD student of University Nord Riho Viik tries to reveal the basic elements of the formal structure of legal acts and contracts and has found some astonishing parallels between seemingly 'remote' phenomena. That should give a new impetus to this disputable area. A lengthier article by Katarina Pijetlovic is also a pioneering paper, which addresses the issues of the application of EU laws in the field of sports. Master level graduate of IUA Ranno Tingas won the Swiss Baltic Net (SBN) Graduate Award for the best graduate research paper among International University Audentes graduates in 2008 and was requested to write an article on the basis of his outstanding Master's thesis. Since 2005 all of the SBN Graduate Award winning papers in IUA have been published, which allows us to say that this has become a good tradition. In his Master's thesis Ranno Tingas dealt with the problems of contradictions between Estonian legislation and European Court of Justice case law in the field of taxation. However, in early 2009 Estonian Parliament adopted some new legislative acts amending Estonian income tax legislation, which put end to these inconsistencies.

The Associate Professor James O'Neil continues his critical approach to the modern views in economics, which he started in the Proceedings of Audentes University, No. 7 (2005) and the Proceedings of the Institute for European Studies, No. 3 (2007). This time he takes advantage of a well-known metaphor of Plato's Cave to explain the obscurity of the some influential views in modern economic thinking.

In their article a PhD student of Estonian Business School (EBS) Tõnu Kaarelson and the Professor of EBS Ruth Alas give an overview of the development of the human resources management in Estonia. The article summarizes the results of the main surveys conducted in this field and gives a better understanding of the entire concept and related trends and developments. The concluding contribution of the collection is an essay-like writing by the Professor Alec Charles from the United Kingdom which is dedicated to the movies of Alfred Hitchcock - a British born American film director. Analyzing Hitchcock movies the author refers to a wide range of psychoanalytical and poststructuralist interpretations of Hitchcock's symbolism.

Let us hope that the readers of the current collection will find it both knowledgeable and full of fresh ideas that could have positive impact on their way of thinking. At the same time it is also an evidence of the lasting potential of the former IUA and its cooperation partners in the field of research and publishing. We are confident that this potential will be even better used in the circumstances of a large public university – Tallinn University of Technology.

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Alec Charles, PhD, completed his doctorate at Oxford University in 1995. He has worked as a journalist for BBC Radio and the Baltic Times, and has taught at universities in Britain, Estonia and Japan. His recent publications include work on British television, media theory and the films of Tod Browning. He has served as Professor of Media at Audentes University and is currently Senior Lecturer in Media at the University of Bedfordshire, where he also serves as Field Chair in Art & Design and Chair of the Ethics Committee for Creative Arts, Technologies and Science. He also leads the Journalism & Communication Research Group, and serves as a member of the University's Research Degree Committee.

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James E. O'Neil, PhD, obtained his first degrees in Economics at SUNY College at Buffalo (State of New York). In 1994 he defended his PhD at the State University of New York, Binghamton. Since 1994 he has been working as a Professor and research coordinator at Concordia International University in Estonia and International University Audentes. Currently he is an Associate Professor at Tallinn School of Economics and Business Administration, Tallinn University of Technology. His research interests are related to the theoretical problems of economics and human knowledge. James O'Neil has published an article "Debt culture comes to Germany in the "*Proceedings of the Institute for European Studies, International University Audentes*", No. 3.

Thomas Pedersen, PhD, has studied at the University of Copenhagen (B.A. in history in 1980 and M.A. in political science in 1986). In 1990 he defended his PhD in political science at the same university. He has been working as a lecturer at different universities in Denmark, United Kingdom, Estonia and elsewhere. His scientific interests comprise European Studies, international relations, political theory, cultural history and political philosophy. He is also the author of the monograph "*Politics of Culture: European Identity in Perspective*" (Aarhus University Press 2008).

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SECTION I: POLITICAL PHILOSOPHY AND INTERDISCIPLINARY STUDIES

Kant's Categorical Imperative and National Socialism

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Summary: *Kant's categorical imperative, to act in such a way that the maxim of one's actions could be the basis of a universal law, has been interpreted in most Western countries in humanist and universalist terms. A different interpretation, however, has developed among some rightwing Kantians, including the French National Socialist writer Maurice Barres, which argues that so far from advocating a universalist or humanist ethos, the categorical imperative should be understood as a principle which justifies self-sacrifice in defense of the nation, or, in other words, not only nationalism but militarism as well. Among others, and perhaps not coincidentally, Adolf Eichmann, one of the main perpetrators of the Nazi Holocaust, seems to have had a similar interpretation. Given some of Kant's writings on national and racial characteristics and identity, such a reading should not necessarily be dismissed as contrary to Kant's intentions.*

In Hannah Arendt's now classic work, *Eichmann in Jerusalem*, the author records an exchange between Adolf Eichmann, one of the main functionaries in the Nazi Final Solution, (the Holocaust) and one of the judges at his trial; in this exchange, Eichmann claims that he has lived his life according to Kant's Categorical Imperative. Asked to elaborate by the judge, Eichmann gives what Arendt judges a reasonably correct formulation of Kant's ethical principle. He says, "I meant by my remark about Kant that the principle of my will must always be such that it can become the principle of general laws," and adds that he had read Kant's *Critique of Practical Reason*. (Arendt 1992, 136)

Arendt seems astonished to hear Eichmann invoking Kant during his trial and describes the judge at the trial as also being surprised. Arendt hypothesizes that Eichmann had distorted Kant's concept to mean that one should follow Hitler's law as if it were one's own (op. cit. 136–137) and concludes:

Much of the horribly painstaking thoroughness in the execution of the Final Solution—a thoroughness that usually strikes the observer as typically German,

or else as characteristic of the perfect bureaucrat—can be traced to the odd notion, indeed very common in Germany, that to be law-abiding means not merely to obey the laws but to act as though one were the legislator of the laws that one obeys. Hence the conviction that nothing less than going beyond the call of duty will do. (op. cit. 137)

Arendt bases her conclusions regarding Eichmann's interpretation of Kant on her belief that Eichmann was a man of inferior intelligence and assumes that he would be unable to correctly understand Kant's moral philosophy. This picture of Eichmann is at odds, however, with at least some of Eichmann's other biographers who regard him as an intelligent and capable administrator. And even if it were true that Eichmann himself had distorted Kantian principles in his own mind, this does not explain why the great majority of German academic philosophers, including Kantians, unhesitatingly embraced National Socialism, nor does it explain the popularity of Kant's works in Nazi Germany.[1]

Kant is generally regarded as one of the greatest 'Enlightenment' figures in German philosophy and German letters in general. Among his works are a defense of the Enlightenment which calls on its readers to think for themselves ("What is Enlightenment?"), an attack on racism ("On the Different Races of Man"), a plan for peace built on international cooperation ("On Eternal Peace") and various works arguing for the necessity of the free play of ideas. How then, one might ask, could his ideas, and particularly his ideas on morals, be reconciled with, and even used to support, the ideas of Nazism?

In *The Origins of Totalitarianism*, Hannah Arendt noted several parallels and links between the rise of Nazism in the 1930s and the surge of anti-Semitism in France during the crisis of the Dreyfus Affair (1894-1918) (Arendt 1979, 89ff.). The backdrop to the Affair was the loss by France of Alsace and Lorraine in the Franco-Prussian War, leading to the rise of a militaristic, right-wing, and anti-Semitic faction in France who called for a 'war of revenge' against Germany to regain the provinces. The parallel goes so far that one anti-Dreyfusard political leader formulated a philosophy of *Socialisme Nationale* (National Socialism). His name was Maurice Barrès[2].

[1] The *Verlag von Felix Meiner in Leipzig*, a publisher of cheap, mass market paperback editions of philosophical works lists three works by Kant, including the *Critique of Practical Reason* and Kant's *Anthropology*, among the sixteen newly published works in 1944. Among the other works in the series are the nationalistic writings of Johann Gottlieb Fichte and G. W. F. Hegel as well as general classics in philosophy by Plato, Aristotle, etc. It should be noted that these works appeared not only during a time of heavy censorship but also during a paper shortage.

Barrès was a literary critic, a supporter of the Symbolist movement in literature, and a popular novelist in addition to being an anti-Dreyfusard member of the French Parliament. Among his early admirers was Leon Blum, a Jew and the first Socialist Prime Minister of France.

Barrès' first works of fiction were a trilogy titled *Le culte du moi* (*The Cult of the Self*) about a young man who is both appalled by the loss of spiritual values which surround him and the lack of any real alternative (and some, therefore, have seen Barrès as anticipating the Existentialism of writers like Sartre). In the climax to the third novel the protagonist finds his true purpose in Nationalism, as the soil of France literally calls to him to defend it.

One of Barrès' later works is another trilogy of works titled collectively *The Novel of National Energy.* In this work the author seeks to analyze the causes of national weakness and a prescription for its remedy (the novel discusses the contemporary issues in French politics of the rise and fall of Boulangism and the Panama Scandal) blending factual occurrences and real persons with fictional characters. The main characters are a group of boys from the province of Lorraine, who, spurred by their cosmopolitan, Kantian schoolmaster leave their homes for Paris.

In the first of these novels, *Les Déracinés* (*The Uprooted*), the boys are told about Kant's Categorical Imperative, to act in such a way that one's actions could be made a rule, which is further interpreted to mean that one should submit oneself to the nation's laws and to one's superiors (Barrès 1897, 26).

Later on in Paris one of the boys, Maurice Roemerspacher, meets Hippolyte Taine, a real-life literary historian and theorist.[3] Taine walks with the boy to Napoleon's

[2] Barrès' National Socialism was a political party and theory calling on the nation to set aside political and class differences in the interest of unifying the workers, industry and the military, the sources of 'national energy' for a war against Germany. Barrès' policy, like its later namesake, was anti-Semitic in tone, although this was not its main message. His political theory owed something to Bismarck's concept of 'revolution from above' and some of Bismarck's political reforms. Its closest intellectual cousin, however, is Benito Mussolini's 'Corporatism'.

[3] Taine is known for his development of the historical approach to literature. He argued that an author's work is determined by his race (or nation), his milieu, and the age in which he lives. His work was influenced by German writers like Johann Gottfried Herder and Madame de Staël and his work was in turn alluded to by Friedrich Nietzsche in his *Ecce Homo*. The character of Roemerspacher is based on the nationalist writer Charles Maurras, a monarchist and founder of the newspaper and political movement Action Française. The meeting between Maurras and Taine actually took place. Maurras was tried and condemned to life imprisonment in 1945 for publishing articles denouncing Jews during the occupation.

tomb at *Les Invalides* and points to a tree touching the outer wall of the building. The life of the tree, he tells him, is like the life of the nation itself, its struggles, its life and death.

Later, Roemerspacher gives his own interpretation to Taine's words and extends his metaphor. Each individual is like a leaf on the tree and the tree itself is like the nation; the nation gives sustenance to the individual and the individual owes everything to the nation. While each individual, like every leaf, may die, the nation will live on after them. In sacrificing one's life for the nation, and preserving it, one gains immortality of sorts through the continued life of the tree.

Further, Taine explains to Roemerspacher, each collectivity (or nation) exists according to its own laws of development, which cannot be understood in its essence by another collectivity.

Roemerspacher reflects on both the words of Taine and of his Lorrainian teacher to create his own creed: Since every collectivity lives according to its own principles and no nation can understand or share in the principles of another, Kant's principle in truth should be that every individual has the duty to sacrifice himself for the collectivity, to act in a moral way is thus to act in such a way that one's actions serve the nation.

By extension it is implied that service to the nation involves sacrifice of oneself in time of war, and further that the destruction of other nations may not only be necessary but morally justified (op. cit. 187-235).

Thus Kant's moral argument, combined with a (very modern) cultural relativism, arrives at a position in Barrès' work very close to Eichmann's Nazi morality. Eichmann's interpretation of Kant's Categorical Imperative may not, therefore, be either as particularly weak-minded or as particularly German as Arendt implies.

But how much of a distortion of Kant's original idea is Barrès' interpretation? Can a case be made for making Kant into an authoritarian nationalist? For Barrès, it is the internationalists who have distorted Kant; just as they have erroneously made the pious philosopher into an atheist to serve their own prejudices, they have overlooked Kant's own loyal patriotism. Kant himself, Barrès argues, would have been appalled to see what contemporary philosophers had made of his ideas.

Although it is true, as noted earlier, that Kant wrote an influential essay criticizing racism (as well as many texts in defense of Enlightenment liberalism and pacifism),

in his *Anthopologie in Pragmatischer Hinsicht* (*Anthropology*) one finds the author frequently falling into many of the prejudices of his time regarding nations and races. One finds him explaining the 'Spanish temperament' as a result of the 'mixture of Arab and European blood' for example (Kant 1800, 303) and describing the French and English nations as "the most civilized in Europe" (296-297).

Today Kant's *Anthropology* is almost a lost work. It is rarely cited among his major philosophical efforts, and indeed its intellectual merit is dubious. Nevertheless, as cited earlier (see note 1) the *Anthropology* was reissued by the Nazis and apparently widely circulated. If we were to combine the Kant of the *Anthropology* with the Kant of the *Critique of Practical Reason*, as the Nazis may have done, we might not be far off from the result which Barrès reached when he combined the ideas of Kant and Taine. If each nation's temperament is determined more by blood than reason or history, as Kant implies, can any two nations of differing 'bloods' really understand one another? If they cannot, how can any moral concept be truly universal? Further, if any nation is more 'civilized' than any other, wouldn't this argue for 'superior bloods'? Kant, with little distortion, could be interpreted then to be arguing that each individual should disregard their own needs and desires and submit themselves to the needs of the blood of their nation. Civilization itself would seem to demand it.

Many historians have blamed the rise of Nazism on the lack of an Enlightenment tradition in Germany and other 'national traits' specific to Germany. Perhaps, however, the intellectual precursors of and bases for Nazism's rise should be looked for not only in Germany but more broadly in the intellectual traditions of the West, even in some of those traditions which we hold most dear.

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Strategies for theoretical innovation: The importance of area-studies and interdisciplinary thinking

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Introduction

All social science phenomena contain a *sui generis* element. An interesting question is, whether area-studies such as studies of the EU tend to be *sui generis* to the point of making established, general concepts and theories useless as vehicles of analysis. Here one ought perhaps to insert the caveat that there are few genuine "universal" concepts in political and social science. Many theoretical concepts to varying degrees reflect the particular reality of a specific, historical context. Methodological concepts, on the other hand, can be said to possess a higher "universality content".
Sartre once quipped paraphrasing the artist Wols that in order to speak universally, one ought to behave as half Marsian, half human or in another sarcastic, Sartrean formulation to look at the world with inhuman eyes. Though Wols undoubtedly has a point, the perspective of this paper is closer to earth. I think one ought also to listen to the science historian, Stephen Jay Gould, who argues that... "creative science is always a mixture of facts and ideas. Great thinkers are not those who can free their mind from cultural baggage and think and observe objectively (for such a thing is impossible), but people who use their milieu creatively rather than as a constraint" (Gould, 1988: 103).

Here EU-studies will be used as a case illustrating more general problems within political science to do with theoretical innovation and the linkage between area-studies and general theory. One of the long-standing controversies among analysts of the EU is the question, whether European integration ought to be characterized as a "normal" or a "unique" phenomenon. At a more abstract level this amounts to asking, how the EU-scholarship fits into the long-standing debate within social science between area studies and discipline-oriented social science aiming for universal explanatory theory. There is an interesting sociology-of-knowledge dimension to this debate (Rosamond, 2003; Wæver, 1998). Here the focus will however be upon the theoretical issues involved.

Let us examine EU-studies as a case in point. EU-studies are confronted with three inter-disciplinary challenges:

- how to relate area-specific knowledge to general theory;
- how to combine insights from various disciplines in order to capture the complexity of the EU phenomenon;
- how to make use of insights from disciplines beyond political and social science.

In a sense EU-studies has already come to constitute a microcosm of widespread debates within political science. The EU is not a phenomenon that can be explained by means of a single concept or theory. Instead one has to differentiate the dependent variable with a view to combining various concepts and theoretical perspectives. Far from marketing one specific concept as the "solution" to the puzzle of the EU, this paper weighs the relative use of a range of concepts and theoretical perspectives relevant to the study of the EU polity and asks, how the study of the EU relates to general theory. This approach is in keeping with complexity theory in the natural sciences, which has been shown to be of relevance to the social sciences as well (Geyer, 2003). In Geyer´s words: "complexity theory does not disprove the rationalist paradigm or its antithesis (reflectivism), but acts like a synthesis or bridge between the naturalism of rationalism and the anti-naturalism of reflectivism and creates a new framework which bridges the two opposing positions" (Geyer:25). Humanity is not inherently orderly or disorderly but both.

More generally, the paper discusses three alternative solutions to the problem of the inter-relationship between area-studies and general theory: (i) Using area-related concepts (national analogies and ideal-types) "out-of-area" and as sources of inspiration in theory-generation (ii) modifying established concepts and theories such as state, federation and democracy (iii) arguing in terms of historical ideal-types. It is argued that while area-studies should not isolate themselves, general theory and even paradigmatic theory may draw inspiration from area-oriented concepts. Finally, on the basis of the discussion of the example of EU-studies, an attempt is made to fit area-studies into a broader research framework, which ensures interaction between general theory and area-studies and makes research more relevant to policy-makers.

The inter-disciplinary challenge

It is important to note that at least when it comes to explaining a complex phenomenon such as the EU political science is confronted with more than one inter-disciplinary challenge: First of all, there is the inter-disciplinary challenge WITHIN political science. This is an important challenge, but not the only one. Secondly, there is the challenge of incorporating useful insights from disciplines OUTSIDE political science. Thus the relationship between History and Political Science – and to some extent also between Political Science and Anthropology – is an often neglected dimension of the Area-Studies debate. For example it is probably fair to say that most area-studies involve... "a process of empathetic understanding or "Verstehen" "typical" of historical studies (Schroeder, 1997). Finally, the question is what role EU area specialists should play in relation to general theoretical debates and the various disciplines.

Turning to the inter-disciplinary challenge within political science many – but not all – EU-scholars today recognize the need for EU-studies to embrace more than one discipline. Some influential IR-scholars thus insist that a single IR-theory – be it globalization or structural realism – can explain the most important aspects of EU-politics. Inspired by scholars such as Kenneth Waltz these scholars make a plea for parsimony and challenge EU-studies to "break-out" of their narrow-minded, single case reasoning (Waltz, 1979). Similarly sociologists such as Habermas have in recent years ventured into the field of EU-studies claiming that the EU should be seen as a phenomenon relating to globalization and late modernisation, more specifically to the emergence of new forms of deliberative and post-national democracy (Eriksen & Fossum & Menedez, 2004). Significantly, however, even Habermas recognizes that… "a constitution will not be enough a European federal state will have to assume a different form than other federal states and will not be able to simply copy their paths towards legitimation" (Habermas, 2003: 98).

Clearly, the study of day-to-day politics in the EU nowadays requires i.e. the application of insights from administrative science and Comparative Politics. In many policy areas the EU indisputably constitutes a political system making authoritative decisions with effects upon European society. The high institutional density of the EU has moreover prompted a range of studies of day-to-day politics using institutional theory. Formal constitutional politics in the EU can best be studied from the perspective of Comparative Politics and Legal Studies. It has been shown, how the EU polity can usefully be compared to existing national polities e.g. the Swiss and German federations. Significantly, in recent years EU-

scholars have undertaken interesting research at the frontier between legal studies and political science. A neo-constitutionalist literature on the EU has emerged encompassing both constructivist and Comparative Politics perspectives (Weiler 1999; Weiler et al., 1986.; Wind, 2001). EU-politics have been shown to contain an important informal dimension (Middlemas, 1995; Pedersen, 1998). At the level of what I would call informal constitutional politics, it makes sense to involve IR with its emphasis upon relative gains and state strategy. Since the introduction of supranational majority voting in a range of areas and the emergence of a widespread concern about a democratic deficit in the EU sociological concepts such as identity have moreover become part and parcel of EU-studies (see Pedersen, 2008)[1].

The key question in this connection is whether a supranational majority rule in Europe can remain stable unless underpinned by some measure of common political identity. It may be argued that high politics overlaps with constitutional politics. Yet, the former concept traditionally has a more precise meaning denoting decisions on the crucial foreign policy and security issues (Hoffmann, 1966). In this area, IR theories remain highly relevant to EU-studies. The study of the EU is special in that one is studying a moving target, that is an evolving polity. The analysis of the evolution of European regionalism can be studied from the perspective of IR theory as well as from the perspective of historical institutionalism (CP) and sociology. Yet, given the centrality of state actors in history-making EU-decisions, IR theory is probably best qualified to answer questions regarding this aspect. Finally, and not least, if one wants to study the nature, preconditions or prospects for a European identity, or simply European values, one is forced to transcend the border between social science and the humanities.

Main theoretical approaches to the study of the EU

Apart from differentiation a conspicuous feature of EU-studies in recent years has been theoretical pluralism. The key debates have involved the disciplines of IR and CP. CP has made significant inroads into the field of EU-studies introducing a range of new concepts. Another important distinction concerns the level of ambition of theories and concepts. Here we may distinguish between area-related and general theories and concepts. As pointed out by Hix, a number of theories within IR and CP display significant similarities as regards basic assumptions

[1] In my book The Politics of Culture: European identity in perspective, I argue that we have to transcend the sociological approach to identity and culture in order to grasp the new individualization of phenomena like nationality.

(Hix, 1994). The dialogue between related CP and IR theories thus seems very promising. For instance rational institutionalism shares some basic assumptions with realism within IR.

What then are the main theoretical approaches to the study of the EU? Figure below provides an overview.

Figure 1. Theories and concepts in the study of the EU.

Discipline	Type of knowledge	
	Area-related	General
International politics	Spill-over Supra-nationality Applied constructivism Multi-level governance	Constructivism Functionalism Liberal inter-governmentalism Modified realism
Comparative politics	Multi-level governance	Cooperative federalism Consociationalism Rational institutionalism

Within area-oriented studies of the EU new concepts have emerged the most important probably being the concept of Multi-level-governance (MLG), which has already spawned a number of studies (see below). Governance is used both within IR and comparative politics (Kjær, 2004). It is however fair to say that the bulk of the literature on the EU using this term come from the CP tradition. As noted above, while constructivism is generally regarded as an IR theory, applied constructivist studies tend to argue very much in terms of area-specific dynamics. Legal constructivists thus point to the construction of a specific European constitutionalism (Weiler, 1999). Thomas Diez in his now famous duel with Moravcsik challenged the latter´s claim that the EU is not *sui generis* arguing that... ”despite their diversity, they (i.e. constructivists, TP) share the argument that European integration and the emerging system of European governance cannot be understood without looking into the historical, cultural, social, institutional and discursive processes implied” (Diez, 1999: 357). Diez goes on to refer to Ruggie´s characterization of the EU as a post-modern polity because of its multi-perspectivity, that is its lack of a single centre of power, single identity and overarching hierarchy

(Ruggie, 1998). Elsewhere in the same text Diez argues that… ”one has to be sensitive to historical context and to include such factors as institutions, ideas and norms”. This strikingly resembles the agenda of traditional historical area studies. Like in descriptive, historical area- studies one looks in vain for an a priori ranking of explanatory factors. There is a sense in which constructivism is a combination of paradigmatic theorizing and area-studies with a scarcity of medium-range theory and testable theoretical propositions.

A typology of concepts

So far we have argued in terms of a simple dichotomy between area-related and general concepts. But the concept of concept is complex. I suggest we distinguish between:

I. classificatory concepts,

II. ideal types and area-oriented concepts,

III. deductive theoretical concepts that is concepts derived from theories,

IV. hybrid and synthesizing concepts reflecting cross-fertilization between general theories and area-studies, and

V. metaphorical concepts

An example of a purely classificatory concept is regionalism. The concept is not derived from a theory. Although it provides a useful umbrella for comparative studies, the concept is elusive. In the huge literature on regionalism the concept is used both to denote sub-national and inter-state collaboration. This however is not necessarily a disadvantage. As stressed by King & Keohane and Verba, when confronted with a scarcity of instances of a given phenomenon, one may increase the number of observations by including similar units at a lower or higher level of aggregation (King et al.). Thus a theory whose original focus was the nation-state might be tested in geographical sub-units of that nation e.g. in regions (King et al. 1994: 219). More recently the concept of regionalism has been extended to encompass activities of non-state actors. Fawcett thus defines regionalism broadly as… ” a policy whereby state and non-state actors cooperate and coordinate strategy within a given region ... the aim of regionalism is to promote common goals in one or more issue areas” (Fawcett, 2004). The concept is mostly used within political economy. Mansfield and Milner thus refer to Fishlow´s and Haggard´s useful distinction between regionalism and regionalization. Regionalism is … ”a political process characterized by economic policy cooperation and coordination

among countries". While economic integration is of key importance in the EU, this definition of regionalism seems too narrow to encompass the broad scope of integration in Europe. Regionalization refers to… " the regional concentration of economic flows" (Mansfield & Milner, 1999: 591). Regionalization is thus related to economic globalization.

Turning to area-related concepts within European studies, as already indicated, the most popular one is probably multi-level governance (MLG). It is a matter for discussion to what extent MLG is an inductive or a deductive concept. While governance is an established and very popular concept within political science it is also a rather contradictory concept and it is difficult to talk about the existence of a genuine theory of governance (Kjær, 2004). There is certainly a strong, inductive aspect to MLG. An off-spring of sectoral studies in structural policy within the EU, MLG has been defined as ... "a claim that the EU has become a polity where authority is dispersed between levels of governance and amongst actors, and where there are significant sectoral variations in governance patterns" (Rosamond, 2000:110). Wallace and Wallace define it as resting on two essential points: "first, that national central governments can no longer monopolize the contacts between the country and the EU levels of policy-making. Secondly, that engagement at the European level creates an opportunity to reinforce a phenomenon of regionalization. The implication is that the domestic polities of the member states are being partially reshaped as a consequence of EU policy-making, in which financial incentives can leverage new political relationships" (Wallace & Wallace, 2000:31f). The emphasis on governance... "takes the debate about authority away from the zero-sum notions associated with discourses of sovereignty" (Rosamond, ibid.).

A key proposition of the theory is that sub-national regions tend to bypass national governments and establish alliances with supranational bodies. The concept resembles that of federation, but it is not quite as concrete and specified. Thus MLG does not describe a polity governed by constitutional rules. To many, it represents an attractive alternative to federalist theory and comparative federalism often criticised for being either too normative or too formalistic. One of the weaknesses of the concept is that it is questionable, whether vertical, multi-level interaction is quite as dense in general as in the specific area of structural policy, where regions are notoriously active players. Moreover, there has been a tendency in the literature using MLG to confuse activity with impact (Wallace & Wallace, ibid.). However, the very simpleness of the concept makes it prima facie useful "out-of-area". I therefore rate its transfer potential as high. The "export" of the concept has, however, so far been limited. Yet, 9 titles in a typical database search show the concept of MLG being

used to analyze other polities than the EU. By way of illustration MLG has been used to study the "political-bureaucratic labyrinth of the Texas school districts".

A variation on the theme of area-specific induction is the attempt by German EU-scholars to use analogies from the German federal state in the study of the EU. Fritz Scharpf has formulated the concepts of "*Politikverflechtung*" and "Joint decision trap" to describe key mechanisms in German cooperative federalism (Scharpf, 1988; Scharpf et al., 1976). These concepts have subsequently been used to study EU-negotiations. Often such national analogies or ideal-types are combined with insights from sociological or administrative theory to produce hybrid concepts or interpretative frameworks. Thus Wolfgang Wessels building on Scharpf has formulated the socalled "Fusion thesis", which describes the... "trends of merging public resources at several state levels" in the EU (Wessels, 1997). National analogies may be useful analytical devices in EU studies. In practice, however, such analyses are often combined with normative considerations to the effect that the phenomenon studied, *in casu* the EU, ought to adapt to the analogy. Ideology is also likely to creep in. While normative considerations do not in themselves constitute a problem, they may result in cognitive dissonance. Caution is therefore warranted, whenever using national analogies.

A number of other inductive concepts have emerged from the study of European integration e.g. subsidiarity, *condominio* (Schmitter), *acquis communautaire*; democratic deficit and subterfuge (Heritier). "Engrenage" also deserves mentioning. *Condominio* and democratic deficit I rate as having a medium transfer potential. *Condominio* describes a model of flexible integration which may be of more general interest but suffers from the limitation that most of the thinking behind the concept can be subsumed under traditional functionalism. *Engrenage* is a variation on the theme of cooptation denoting a strategy of involving actors in the supranational game. Democratic deficit, although more a metaphor than a theoretical concept, does seem to pinpoint a dilemma between democracy on the one hand and political regionalism and international governance on the other. A concept like *acquis communautaire* seems too specific and legalistic to permit transfer to non-European contexts, although as a strategy of soft conditionality the thinking behind the concept of "*acquis*" may be of some general interest. "Europeanisation" also appears to have a limited transfer potential for the simple reason that it assumes a highly institutionalized, supranational polity with significant impact upon national polities. Thus it is doubtful, if it is possible to talk about say a Latinamericanization of Paraguayan society as a result of Mercosur membership, although a more precise answer to this question will have to await empirical analysis.

Of interest is also the rather unwieldy concept of subterfuge, defined by Heritier as... " the widespread and ubiquitous use of informal strategies and process patterns that circumvent political impasses" (Heritier, 1999:1). Subterfuge consists of ... "policy strategies that "make Europe work" against the odds of diversity" (ibid.). Given the fact that the typical decision making mode in most international organizations is unanimity, the concept ought to have a considerable transfer potential. However, much like *Politikverflechtung*, subterfuge is a "loaded" concept in the sense of carrying a number of context-specific connotations. It is idiosyncratic to the point of limiting transfer potential. I therefore rate its potential as only medium.

Significantly, scholars who assume that EU is *sui generis* also discuss democracy in *sui generis* terms. German scholars thus talk about "*Europa-fähigen demokratie-modellen*" and post-parliamentarian democracy (Kohler-Koch, 1998: 18). While thinking in terms of e.g. "output-legitimation" and "network-democracy" is logically coherent, it does involve a risk of lowering the standards of democratic performance (Pedersen, 2002). The so called democratic deficit in the EU may be seen in narrow terms as an institutional challenge to the EU project. But it may also be seen as reflecting problems of democracy typical of globalization and its attendant technocratic problem-solving method. David Held for one has related the experience of the European Parliament to models of global democracy (Held, 1996).

Deductive concepts in the study of the EU include concepts drawn from rational choice institutionalism and neo-realism. The main benefit of such concepts is that they are embedded in general theories and sufficiently abstract to allow for cross-regional testing. For instance in recent years EU-research has seen a proliferation of quantitative studies measuring the power distribution effect of supranational institutions (e.g. Tsebelis, 1995; Hosli, 2001). The problem with such studies is that they turn a blind eye to informal norms of give-and-take, which seem to play an extraordinarily important role in the EU. Just to take one example, to behave according to a "Thatcherite" norm of "*juste retour*" proved in the 1980s to be if not impossible then certainly very difficult for the UK government requiring an extra effort of legitimation. The EU membership is based not on short-term but on long-term utility and involves thinking in broad package-deals. German EU policy constitutes an even better example: As I have shown it centres around a gradualist strategy of regional integration combined with legitimating concessions, a behavioural pattern which is very difficult to explain from the perspective of rational choice or Waltzean neo-realism (Pedersen, 1998). Franco-German relations seem particularly difficult to explain from the perspective of traditional neo-realist theory (Pedersen, 2003).

New synthesising or hybrid concepts may in principle be particularly useful in that they may accommodate the complexity of the EU and serve as catalysts for inter-disciplinary reflection. An example is Moravcsik´s liberal intergovernmentalism, which combines a paradigmatic concept (liberal) and an inductive, theoretical concept – intergovernmentalism. Unfortunately intergovernmentalism is related to a paradigm – realism – the assumptions of which differ fundamentally from those of liberalism. Thus Moravcsik bridges two paradigms, which makes falsification of his theory somewhat difficult and blurs the important links between general theory and paradigmatic development. Synthetic concepts are not always scientifically valid, but as preliminary tools they may be helpful.

Finally, metaphorical concepts have become widespread in political science, mainly as a by-product of growing interaction between the Humanities notably History and political science. How should this trend be evaluated? Metaphors "create similarity" (Montuschi, 2000: 277). It would be wrong to think of metaphors and science as belonging to two different worlds. Great scientists such as Darwin and Einstein believed that the use of the metaphor is vital to the development of scientific ideas. Metaphors may be useful as preliminary steps in the direction of formulating genuine, scientific concepts. However, for a scientist to argue solely in terms of metaphors is a sign of sloppiness. Moreover, in a pluricultural setting the use of metaphors often raises serious problems of misunderstanding. An example of successful use of metaphors is Tanja Börzel´s study of member state responses to Europeanisation (Börzel, 2002). In her important article Börzel describes ideal-type strategies using metaphors such as "foot-dragging", "pace-setting" and "fence-sitting" (Börzel, 2002).

Focusing upon inductive, EU-related concepts, the interesting question is, as already indicated, to what extent such concepts have a "transfer potential" that is to what extent they may be used to study cooperation and conflict in non-European regions and to study regional cooperation more generally. Four criteria seem useful in assessing transfer potential:

- can the concept be subsumed under established theories or concepts?
- Is the level of abstraction too low to make transfer meaningful?
- Are concepts linguistically "loaded" to the extent that they become difficult to transfer? I will call such concepts "non-transferables".
- To what extent are area-oriented concepts innovative ?

On this basis I have tried in a preliminary fashion to measure the transfer potential of a number of area-related concepts in EU-studies (see above). Figure provides a summarizing overview without purporting to be exhaustive.

Figure 2. Area-related concepts in the study of the EU.

Concepts in European studies	Transfer potential		
	High	Medium	Low
Multi-level governance	X		
Democratic deficit		X	
Multi-layered polycentric governance	X		
Subsidiarity		X	
Acquis Communautaire			X
Condominio		X	
Europeanisation			X
Subterfuge		X	
Politikverflechtung		X	

Modifying general concepts

Apart from transferring concepts from area-specific studies to other areas and perhaps even to theory-generating endeavours, there is another promising avenue. This is what I would term modification of general concepts (and theories) in the light of insights from area-studies. It envisages a dialogue between disciplines and area-studies the typical outcome being the modification of well-known concepts or theories. Thus in this model disciplines tend to serve as torches helping scholars find a path in the dark. As an alternative to purely inductive theory this is a promising research strategy. It takes seriously the sound, positivistic principle of cumulation according to which scholars should think and act inter-subjectively as members of a community of scholars. There is no need to devise new concepts and theories, if a new insight can be captured by a modification of existing concepts or theories. One of the drawbacks of much constructivism is precisely its tendency to want to "build new conceptual bridges" when crossing rivers, where bridges are already available and solid.

To return to my basic point case studies within geographical areas may help us further develop existing theories and concepts formulating what Alexander George has called "rich theories" (George, 1997ff). For instance, Weiler makes the point that the EU is a federal non-state (Making sense of the EU: 53). Here the EU is contrasted with established notions of the state in a very promising way.

Thus established concepts such as governance, state and democracy have been modified in the light of concrete EU-developments. The EU has i.e. been interpreted as an instance of a new "post-modern state" (Ruggie, 1998; Sørensen, 1999). Sørensen thus regards the post-modern state as being characterized i.a. by multi-level-governance. In a similar vein one might start thinking in terms of "weak nations" typically found in areas transcending nation states within spheres of supranational governance.

Figure 3. Modifying general concepts: Examples.

Pure concept	Modified concept
State	Regulatory state
Hegemony	Cooperative hegemony
Regionalism	Closed regionalism
Federation	Asymmetrical federation
Democracy	Post-national democracy
Globalisation	Regionalisation
Nation	Weak nation

Historical ideal-types and analogies

As pointed out by Alexander George, there is a need to investigate, how lessons of history can be cumulated into policy-relevant theory (George, 1997). Much general theory and all writings on paradigmatic theory are parsimonious to the point of lacking relevance to the complexity of day-to-day decision making. Parsimony is a useful vehicle for breaking out of the prison of encapsulated area-studies. But parsimony also has its drawbacks. As pointed out by Gaddis, parsimonious statements often border on the banal. Far from giving interesting answers they simply raise new questions (Gaddis, 1997). Apart from borrowing from adjacent disciplines within political science International relations scholars studying the EU ought thus to devote attention to the inspiration provided by the discipline of History. Area studies allow the political science scholar to move beyond statistical-

correlational findings to identifying intervening causal processes. But more than that, historical area studies enable the scholar to formulate conditional generalizations, that is to say to diagnose specific, but recurrent problematic situations. As already mentioned, George recommends formulating what he calls "rich" theories, by which he means theories that embrace many variables.

Finally, and perhaps most importantly, interaction between History and Political Science provides an opportunity for thinking in terms of historical ideal-types. The ideal-type is often a useful tool for generating medium-range concepts and theories. It seeks to generalize while remaining sensitive to context. The problem with scholarship using ideal-types is that often it fails to aggregate ideal-types into a coherent, general theory. Historical ideal-types (and historical analogies) seem, however, particularly useful in trying to formulate medium-range theories and conditional generalizations. For instance, the study of statecraft and grand strategy can benefit from investigating a range of strategic responses to the same structural challenge.

More pertinently, within the area of European integration studies, it seems possible to formulate e.g. historical ideal types relating to integration strategies and crisis management strategies. An example of a historical ideal-type used in the EU-literature is "the new medievalism". What scholars have in mind when using this term is a political order characterized not by exclusive territorial rule but by multiple allegiances and overlapping jurisdictions? Like in the European Middle Ages, it is argued, Europeans today typically have multiple identities. This analogy has already spawned a range of studies, some sticking to the metaphor, others going further in the direction of theory-generation.

However, the example of new medievalism also shows the risks involved in using historical ideal-types: There is no mentioning of the fact that the middle ages was a highly elitist society, in which access to the circle of European free-movers depended upon mastery of latin, and in which social identity was rather rigid. Nor is it taken into account that the Middle Ages was a period, during which violence was rampant and ever-present. This has not, however, prevented historically inclined EU-scholars from using the new medievalism analogy to demonstrate the possibility of having multiple identities. In other words, it seems as though historical analogies or ideal-types are most useful, when it comes to thinking in prescriptive terms. The use of historical ideal-types and analogies thus seems particularly helpful from the point of view of offering policy-advice. Another example of a potentially useful historical analogy is the "*Ausgleich*" arrangement between the Hungarians and

the other peoples within the Austrian-Hungarian Empire introduced in 1867. The *Ausgleich* could be said to constitute an interesting example of power-sharing.

Area studies and general theory

Although an attempt should be made to avoid isolating area studies from general theory development within the political science disciplines, it should not be overlooked that historically-oriented area studies may help inspire theory development. It also should not be overlooked that much paradigmatic theorizing has in recent years been just as inward-looking as mainstream area studies. Islands of philosophical speculation have emerged in the so called scholarly literature, which have a very tenuous relationship to the continent of positivistic or modified positivistic political science. Area-studies also allow us to make highly abstract theories testable beyond statistical correlation by specifying the time and place conditions under which certain theoretical propositions are valid. A final point concerns policy advice. Neither paradigmatic theory nor general theory is normally of use to policy makers. This by no means makes such theorizing irrelevant. In fact, scientific freedom is one of the Western values that the rest of the globe still regards as standard-setting for the world at large. But it should serve as a reminder to theoretically minded political scientists to pay due attention to specific theory and deep empirical analysis with a view to pinpointing historical ideal-types and undertaking context-sensitive, conditional generalization, both of which are highly relevant to policy-makers.

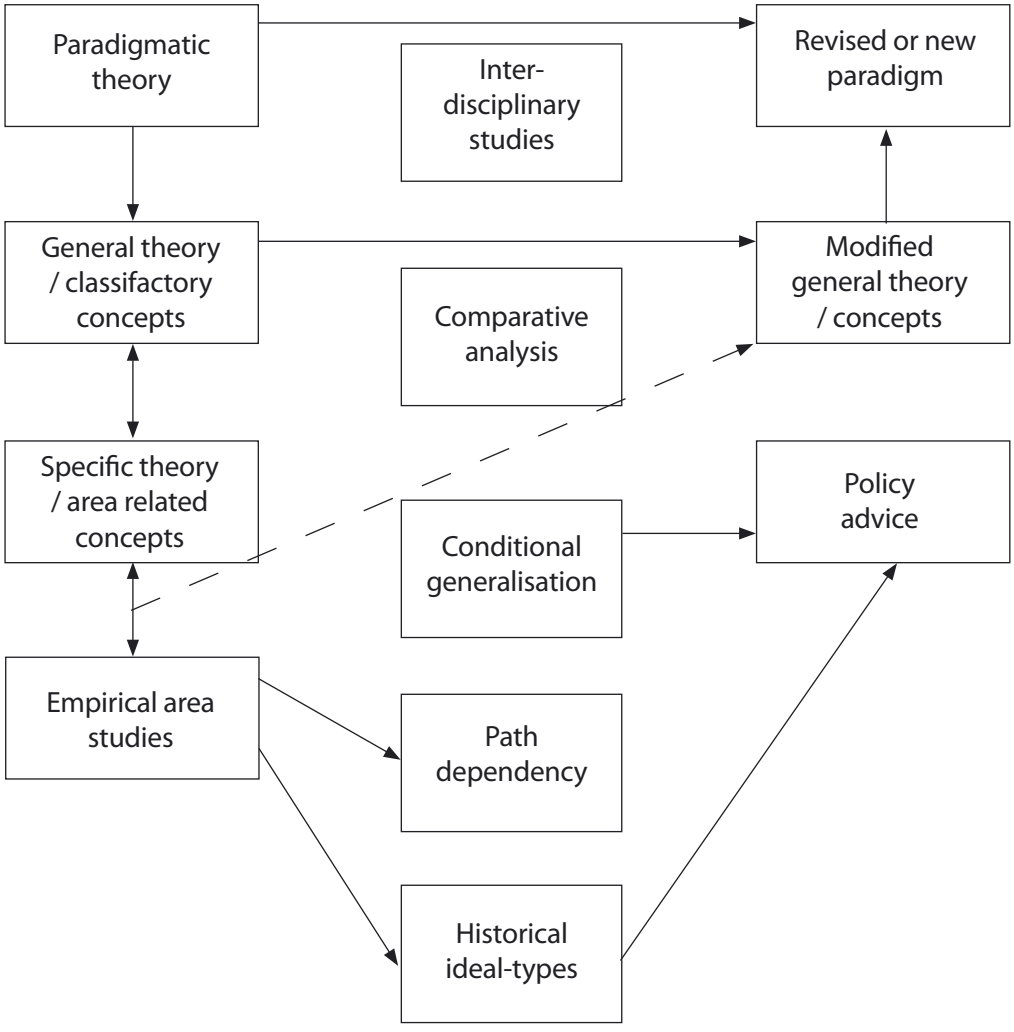
While naive positivism has now largely been abandoned within political science, it would be misguided to appease post-modernist relativists and in so doing lower academic standards. To assume that observation is theory-laden does not imply that an objective world does not exist, distinct from the subjective beliefs of the observer (Haber et al., 1997). Haber et al. use the excellent example of American dollars: Clearly... ” we can only use green pieces of paper in exchange for products in the US because individuals share the view that these green pieces of paper are valuable. Yet this... does not preclude an observer from validating claims that green pieces of paper can be used to purchase products, whereas pink ones cannot.”

Below I try by way of summary to fit area studies into a broader research framework: Ideally, empirical area studies would inspire general theory and through modification of theories and concepts potentially even paradigmatic theory. Paradigmatic debates as well as the formulation of general theory should seek inspiration in interdisciplinary

perspectives. The development of general theory such as theories of the state would lean heavily upon comparative analysis, but might also profit from area related concepts and "thick" empirical area studies. There is a thin dividing line between modification of general concepts in the light of area-evidence and the use of areas or regions as mere cases in a deductive theoretical framework.

Historically inspired area-studies will i.e. result in conditional generalization that is specification of a set of circumstances leading to certain recurring actor responses. For instance one may study responses to various types of political crises. Empirical

Figure 4. Area-studies and general theory: A framework for research



area studies such as studies of the EU may lead to the identification of context-specific, self-reinforcing mechanisms (path-dependency) and may involve the use of ideal-types with the history of the area being used as a source of inspiration.

All too often, it seems that paradigmatic debates are de-coupled from area-research and area-specific theory. Besides, disciplines tend to overlook and perhaps even denigrate the need for policy-advice, a need that can rarely be fulfilled without interpretative area-studies. But area-oriented think-tanks should endeavour to keep open the lines of communication to general theoretical debates. The scholarly community should not be fragmented into inward-looking and self-congratulatory islands of knowledge. Such islands tend to become vulnerable to invasion from political, ideological and economic centers of power, although in the short term they may seem to outdistance their competitors from basic science.

Conclusion

As I have tried to show, the relationship between area-theory and universal, explanatory theory is not a one-way street. While area specialists should avoid isolating themselves from general theoretical debates within the disciplines, discipline theorists and scholars studying adjacent areas should be more open-minded and take seriously the possibilities, area studies may offer for generating new concepts or modifying existing ones. In the existing literature this potential appears often not to have been exploited to the full. The main problem in contemporary social science theoretizing seems to be detachment from reality and running around in paradigmatic circles in a playfulness that may be satisfying for the participants but does not add much to scientific learning. Often as in the case of European Union studies, area-studies can provide inspiring lessons in inter-disciplinary thinking. Whereas in the old days, the learned person was the person, who knew several languages, today this is not enough. Today's learned person is pluri-disciplinary. To some extent I thus think we ought to revert to the ideal of the polyhistor, at least as an inspiring ideal-type.

Disciplines tend to develop their own defensive norms of appropriate behaviour. Such norms can be a barrier to innovative, inter-disciplinary thinking. It must be recalled that while disciplines may be a helpful tool of scientific cumulation, they remain precisely tools. There is a constant risk of reification of disciplines.
The link between neo-functionalist theory and interdependence theory is an early instance of how area theory may inspire general IR theory. As we have seen, some of the inductive concepts deriving from contemporary EU-studies (e.g. multi-level-governance and subterfuge) also have some "transfer potential". Likewise, national

analogies can be useful, although such perspectives ought to be used as a supplementary tool alongside general concepts and theories. It has moreover been argued in this paper that simplistic rational choice models ought to be used with great care. In the case of the EU, for instance, specific ideas and norms of power-sharing and commitment appear to have taken root in the light of a unique, historical experience.

Part of the trouble in contemporary International Relations is the scarcity of medium-range theory bridging the two perspectives of area-studies and general theory. Examining the "transfer potential" of various context-related concepts may be one useful starting point for theoretical innovators. Another key problem is the tendency within parts of the social sciences to sever the link between paradigmatic debates and the development of specific theory.

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SECTION II: LEGAL ISSUES

About the fractality of contracts and laws as regulatory systems

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This article introduces the use of a new scientific method in law, called **regulatory analysis,** which can be used to examine the structure of legal texts as regulatory structures. Contracts and laws have been in use for thousands of years, but the basis of their creational system has been undiscovered until now, the included regulatory elements have been unclassified and the deep structural level has remained undescribed. This paper demonstrates how regulatory elements of contracts or laws can be classified based on regulatory types. Also, for the first time, the fractal structures of contracts and laws as regulatory systems are included in the appendices.

Fractal Models for Fractal Systems

Regulatory systems in law are compiled in verbal or written form, usually as carefully written texts in the form of contracts or laws. These regulators include within them several different types of regulatory elements that are observed as fractal elements, meaning structured self-similarities of different system levels, or as regulatory invariant, subsystems that are developed in more detailed form (in case several levels or **fractal level**s exist). The self-similarity of contract elements can easily be demonstrated: **each contract element, or agreement on some certain concrete condition, can be considered as if it were a separate contract**, a sub-contract. The contract element is similar to the contract. This feature is called fractality. Describing the regulatory structure of a law or contract be accomplished by using fractality. It is, however, important to find out why fractality occurs, because the different levels of or **wide-scale self-similarity relies on some basis that regenerates such uniformity.**

Contracts and laws regulate something, overcome contradictions. They are judicial regulators, which consist of conditions, clauses, provisions or, when generalised,

regulatory elements. When needed the regulatory elements can be developed and each specific element can be rewritten in a more precise way by adding levels or sublevels to the system. In this manner, regulatory elements can be created that support the existence of an element and transform the so far element in turn into a subsystem containing sub-elements. This can be repeated several times, creating a hierarchy of structural levels. This way of writing in **self-similar detailing** has been in the history of law one of the techniques of lengthening contracts and laws that is now magnified in text processing by the use of computers.

When analysing the elements of contracts and laws, it was discovered that in the same functional cluster there is a total of up to six linked elements. The function of each element (now the element as a system) enables the sublevel in return to have, similar to itself, up to six sub-elements. This kind of structure is repeated on every fractal level. For example, in a contract the element of *reciprocity* is divided into regulatory sub-elements that logically follow one another: a *promise in return*, which has a *price* that is paid in accordance to the payment conditions, through which fulfilment is enabled with *legal remedies*, in which collection is guaranteed by a *payment warranty* and in case the aforementioned is insufficient, it is secured by some *insurance* of parallel means. A natural question arises: why are there exactly six elements that belong together and not sever or five? Such a final number is also represented elsewhere – an object has six freedom levels in space, the power dimension has six units, etc. The short answer is that there are only six regulatory types, which are all used in sequence. Therefore a number other than six can be observed only in cases of imperfection, when some possible regulatory element is missing from a text or for some reason the same regulation is presented repetitiously.

The main methodological novelty in regulatory analyses other than fractality is the use of a six-element regulatory sequence. Namely, the six cohesive elements in the system (or subsystem) of the same level are all differently regulative. These different regulative forms can be named **regulative types.** Each regulatory type performs its function in a different regulatory form, such as a "yes-no" form, direct binding form, backwards binding form, etc. Fractality or self-similarity actually arises from the fact that while regulation is performed in a more developed and detailed manner on each element's subsidiary level (next fractal level), it is still performed within the same six types of regulation. This self-similarity repeats on each fractal level. How many levels are applied in a regulation depends on the development and details of the contract or law. For example, when buying bread from a shop, it is sufficient for a contract to develop elements on one level without

sublevels; when registering the purchase of a house at a notary's office, and then in the long contract, which regulates purchase details, the use of three or four levels is appropriate.

This kind of development sequence which is formed based on six regulatory types can be used as a invariant structure where something develops step-by-step, when regulatory proceedings are performed, or if the established regulation of this self-regulative entirety is examined from level to level. The exploratory model's systematic nature as a quality has to correspond to something important to the examined system. A qualitatively suitable model does not simplify that which is examined too much and enables it to be presented as a complete system. Contracts and legal acts used in law are structurally fractal and fractal models can be compiled for them (see appendix 1, the analyses of the Personal Data Protection Act (RT I 2007, 24, 127) and in appendix 2 the contract structure, both presented on two fractal levels). When examining their internal self-similar structure as fully systematic, six regulatory types in order of succession are shown as the basis of forming a system. These enable a system to be formed in the whole regulatory range, starting from the simplest regulation up to a complete self-regulation, and a changing regulation to integrated and fully systematic.

When can texts be considered to have systems and in what respects are contracts or laws as systems different from other formations of phrases; for example, from descriptions, thematically gathered combinations of sentences or just from something spoken about during conversation? To broaden the question: what makes a text a systematic entity to be examined fully and systematically? A fully systematic approach employs the systematic approach, but adds qualitatively new elements. The approach here has been distinguished as "fully systematic" from: the "traditional approach", in which the forming basis of the system, principle of forming subsystems, their regulatory distribution of work and explained emergence effect causes are not correctly defined. The definition of "fully systematic" here means that due to the character trait of the system's forming basis it can be claimed that there is an infinite number of regulatory types. At the same time, use of this definition shows a paradigmatic distinction from an ordinary systematic approach, where this kind of division into regulatory types in order of succession has not been taken as the basis for the forming system. **As the forming basis of the system is itself a special entity, then this way the formed system has special emergence or fully systematic features.** One of these is fractality. A text is fully systematic if it contains all regulative types as its elements for a common purpose of regulation, and, if necessary, has a structure with fractal sublevels.

Semantics as a Tool

As words are used in **language games** in accordance with certain forms of life (Wittgenstein, 2005), then when phrasing regulatory elements, some identical regulatory form of life is always intuitively taken as a basis, but in order to make it understandable by a social group, it is explained through their associative language game that can be different every time. In order to avoid possible mistakes and wrong interpretations, the correspondence between phrasing and regulatory form should be controlled, but it is relatively difficult to accomplish without knowing the regulatory types behind the phrasing. Using contracts and laws successfully, the regulatory form hidden in them has to be passed on in the language game and its application should be started. Influencing events in the correct regulatory manner is the prerequisite for managing them successfully.

The **language game is a tool to deliver regulatory form**. It is not important how we refer to a regulatory element in a contract or a law, but how we carry out a specific type of regulation is essential. The language of the text is the tool that is there to form regulations, the same way as the contract or law is a tool to regulate society.

Just as in the real world the laws of logic are valid despite conscience and therefore the real world itself has a logical form, the regulatory types of elements also exist irrespective of their users and non-users' conscience and **the real world has a regulatory form**. There is a contradiction in current dominant cognition: the regulatory types, especially backwards, are often spoken about, but in practice these types are not distinguished. There is no need to recognise or distinguish these types in daily life and there is no experience related to recognising different types. Hence, different regulatory types have been used in the method of trial and error, and also when compiling clauses of legal texts.

Contracts and laws are created in an attempt to try to overcome different contradictions that can occur in practice. Therefore, all the existing regulatory types with phrasing and code of conduct that corresponds to each type have been introduced into these texts. The contradictions likely to occur in reality are presented in the regulatory text instructions to overcome these situations on one or more fractal levels. **Society's social inventions like contracts and law** are therefore regulatory images of reality, prognoses of possible conflicts between parties and offerings of possible solutions. In practice, in order to overcome contradictions, the reasonable possibilities and regulatory types of text regulators have to be in qualitative correspondence, otherwise no efficient regulation is possible.

In technology, when using regulatory analyses with inventions, it has been discovered that in order to overcome (for inventing) technical contradictions, it is necessary to use all six regulatory types fractally (Вийк, 2007a). All these types are fractally used in various fields related to overcoming contradictions, such as in **stratagems** (Вийк, 2007b), fairy tales (Пропп, 1969), hexagrams of the Chinese Book of Changes (Vahur, 2003), psychological processes (Филонов 1992; Пономарев 1976), contracts, laws and **other proceedings related to regulating something lacking**. The qualitative sequence of regulatory types is optimal for carrying out proceedings.

Regulatory elements can be allocated to a multidimensional matrix table and examined by applying **non-parameter matrix analyses**. For example, in correspondence analyses the regulatory suitability and appropriateness of contract or law elements can be examined by comparison with the ideal model. When phrasing regulatory elements some certain regulatory objective is taken into account, but predominantly a suitable regulatory type is constructed intuitively. Regulation is created in casuistic manner, without taking into consideration the regulation's types, and emanating from situation, success and error experience, prototype and intuition. Therefore, composing contracts and laws has so far been regarded as an art than a science. **Correspondence analysis enables us to have conscious control over an element's correspondence as to type as well as over the existence of important regulatory elements.** This decreases the number of mistakes in textual construction.

When analysing complex systems, the common problem is often that there is no tool to examine the system as a whole without simplifying it by breaking the whole into parts and destroying the systematic nature. Methodological tools are from their qualitative level usually lower than the examined, which means that it is not possible to examine systems with involved regulatory nature and structure on a sufficiently qualitative level. Some elements are found, some structural relations, but mostly they do not **deal with the hierarchy, feedback loops, programming and homeostatic hidden in the network of relations of the whole.**

The science of law lacks methods of formalizing legal text systems as self-regulatory bodies. For example, regarding the elements of contracts or laws, there exist **phenomenological descriptions based on empiricism**, but the problem is to find a suitable **tool** to reach **formalised knowledge**. As we know, using formalised language and models, abstracting the examined, taking it into mathematical language, is in reasoned cases characteristic of science. There has been a peculiar

abstract formula along these lines of a legal norm presented by Estonian jurist Ilmar Tammelo (Tammelo 1993, 121–201). The formalisation of the examined object enables one to identify more easily some possible deficiencies, unprocessed material, illogicality and contradictions. Empirical approaches describe repetitions, but do not open their **logical or regulatory causality** and do not answer the question **"why?"** Therefore it is easy to place under suspicion the objectivity, completeness, preciseness and possibility of forecasting the development of events of such fragmentary results that have no uniform basis. For example, the regulatory elements of contracts could be "collected" as before into an empirically thicker and thicker manual and their specialties described in every sophisticated way (Fosbrook & Laing, 2007), but this work would be endless, the result would still be confusing, and the organisation of the discovered information superficial.

At the same time it is still not known which elements should be ideally incorporated and why in contracts with a systematically developed structure or in law. Do these texts even have an invariant structure or does the selection of clauses depend only on a situation? Expanding vast empirical-phenomenological data volumes do not change without cognition's qualitative jump over to higher rank knowledge that would enable us to classify qualitatively the regulations found in this database, to make orientation among these and their implementation simpler and more controllable. It is actually not known how and why a contract or law is made an entirety, as science has not come to it until now. Observing elements as regulators and organised in a fractal structure, as well as gradually hierarchical enables one to understand better what is going on in the entirety, as in the black box.

Using regulatory types and fractal structure enables us now to express the regulations in **formalised language** in contracts and laws. Semantics, knowing the meaning of regulatory elements or indicating them, may not be sufficient enough to compile a precise regulatory text. By using the rules of compiling regulative structures for sentences from sentence compiling teachings or syntax, the new regulatory expression of an element will be more precise, determined and univocal. Ene Grauberg (Grauberg 2005, 3–17) has written about the collapse of the current semantic paradigm. This aforementioned regulatory element is observed in regulatory analyses as a constructed sentence, the regulatory type of which can be determined in syntax. It can be stated that instead of **elements' semantic or indicating designations, regulatory analysis examines the networks of sentences that are used in contracts and laws and have: 1. different regulatory types, 2. fractal structure and 3. hierarchical division of fractal levels**. As compiling a casuistic legal regulator's complex does not guarantee creating a regulatory

system, then it is now principally possible to change from compiling these on an inductive-empirical basis to the deductive-formal compiling. Whilst formally it is possible to determine the type of regulatory event, then based on this contracts and laws can be formalised.

Where can we find a system-creating basis that is fully systematic and enables formalisation? The story is the material for the plot and in an artistic text the creating of a system out of a story can be described with the **plot composition sequence**: *performance – falling action – development – peak – turn – solution.* The same mechanical basis is not used in legal texts. A contract can be written analogically to essay by using the linear narrative necessary to storytelling, but the narrative nature of it does not turn it into a systematic legal regulator. It practically does not matter in which textual part the regulatory element is written, the regulatory power of contracts or law does not change because of it. What causes that? System elements are not an amorphous mass that is presented as a text through words, but despite the form of presentation they are analogical to plot elements in secure and internally very organised relations among themselves. The regulatory, fractally structured and hierarchical relations or, when generalised, form relations of elements of legal regulators could not be described or formalised until now. To understand and deliver such a system, it is necessary to have a respective cognitive model and formalised language.

A structural approach, despite formalisation attempts, cannot transmit the system, because if the respective cognitive model is missing and the hidden regulatory form of a system is not taken into consideration, the formalising is taking place in an impoverishing manner: instead of a system the result in the best case is a complex. This is how Vladimir Propp, who examined functional elements of magic fairytales, found the morphologic invariant made of 31 functions that repeated from fairytale to fairytale (Propp 1969). By using regulatory analysis the author was able to find and arrange into a form of full systematic matrix all the 6x6 functions of the plot or to present on two fractal levels the integral, self-similar structure of the composition of fairytales (Viik 2004, 65–66). It is probably for the same reason that Ilmar Tammelo's attempt to present legal norms as an abstract formula was not successful (Tammelo 1993, pp. 121–201).

Why is the cognitive model corresponding to the examined system so important? In systematic law regulators, there is another quality hidden behind words and empirics, the **regulatory form world**, which so far has not been discovered, described or analysed due to the absence of the respective methods or tools.

Something has still been noticed and described on the phenomenological level. This is how the structural parts and narrative complexes that contain regulatory elements are described. For example, one of the known logical structures of a norm is: a hypothesis, a disposition, a sanction or if…, then…, otherwise.., that has been covered in the last part of the article.

Classification Basis

If in legal texts the elements from different fractal levels can be classified based on regulatory type, then what are elements' regulatory types and how can they be determined? Regulatory type definition originates from **cybernetics** which examines regulation and management. The easiest, or in sequence, the first type in something's regulation is the "yes-no" type – for example, regulation about a contract or law's coming into force: coming into force, "yes", or not coming into force, "no". However, such a simple distribution is not always possible and then other regulatory types are needed.

Although this observation has not been actual, the types of regulation can be classified into a final number: six types. It is possible to collate regulatory types based on efficiency, starting from the most simple up to complete self-regulation through six levels. However, there is an insecure basis for collating efficiency compared to the internal structure's transformation level – wise. On these levels there are basically more and more ideal regulation types.

On each regulatory level is an important improvement to the regulatory mechanism of the previous level is added, a **subsystem that basically enables it to increase regulatory capacity,** such as for a reaction mechanism with a direct binding, a feedback loop from the external environment.

Of these regulatory types, the one that is the most well known in relation to cybernetics development and is most widely used in theory is the backwards type. Usually people are familiar with the "yes – no" type (such as a switch with two positions to switch something on and off) and have heard of direct binding. Often people do not know how to distinguish between direct binding and backwards. Some have also heard of self-regulation or homeostasis, but its achievement mechanism is in most cases unknown. A water tap regulates the flow of running water between "yes-no" with an interim micro regulator, but this cannot often be distinguished as a regulatory type between "yes-no" and an interim. Therefore,

some single regulatory types are known, but these lack complex usage. They do not have a place in the well-known cognitive paradigm. In any case, all the types in daily practice, including law, are widely used. The use of system analyses of regulatory types has great potential.

Regulatory types can be sorted based on their efficiency or structural development. Subsequently, this kind of regulative stages' sequence with examples is described in technique. The **primary** and most simple of regulations is the "yes-no" type, as it is, for example, with an electrical switch, where only two constant positions of connection to the energy source, "yes" or "no", are possible. The regulation that is in principle more flexible than the first one, is the **second** regulatory type, where it is possible to use intermediate statuses between "yes – no" extremes, such as a rheostat or tap as transmission mechanisms constantly to 60% of the maximum.

When speaking of the **third** type, then to the regulation is also added a measuring device, a subsystem which guarantees the active constancy of the still functioning body, such as a well-visualised Watt regulator, that has been used as a pressure regulator on steam engines. This enables the constancy of specific measure or parameter to be regulated (influencing, for example, the position of a rheostat or tap to regulate tension or pressure) or to carry out direct binding. For example, in the case of an electrical stabiliser, the direct binding regulation is kept with 220 volts electricity functioning body for spinning with constant speed. If this directly binding stabilised currency drives with an engine around as functioning body, such as a saw, then depending on the impedance of the material that is sawed, the saw's spinning speed may however fluctuate.

As a **fourth** type, (negative) feedback can be used, through which when influencing the metering device in leading manner and this way by changing the steam pressure or electricity tension keeping, in case of changing sawing impedance, the saw spinning speed constant. In order to choose a constantly optimal spinning speed in changing conditions (that can be different and changing for each object – for sawing a nail in wood, for example, zero) a decision mechanism is used that in return enables leading when inclining backwards binding as **fifth** type programmed regulation.

Optimality can be determined according to a compiled program such as saving energy, working speed, quality, safety, etc. Although it is possible to have many optimum programs here, the goal of each program is to be continuously or constantly optimal in management. As part of the power is still getting lost during regulation,

then this can be used to carry out side processes. When finding side process(es), which are in mutual dependence with the main process, the existing power can be divided among them with a homeostatic regulation mechanism. In this case it is possible to use constantly all the useful utilised power. For example, while sawing, the mutually dependent parallel process is delivering sawing material – the faster the material to be sawed is delivered, the slower the saw is turning due to an increasing obstacle and vice versa. The main process can be managed as the **sixth** type via a mutually dependent, homeostatic parallel process.

The direct main process is not regulated here anymore; the regulatory system is developed to be fully systematic, self-regulative, and the regulation has changed to be ideal through the regulative development stages. This kind of parallel regulation or homeostatic regulation enables the whole power to be put usefully to advantage. Consequently, this is the end of regulatory development levels through overcoming the contradiction of efficiency or due to regulating the main process without regulating the process itself. On each level the possibility to guarantee constancy means permanent regulatory controllability in this regulatory type. In contracts or laws, this means that the respective type of phrasal regulator exists.

When speaking of contracts and laws it is widely spread to use in different subtypes regulators outside regulatory text or parallel regulators. It is important in the case of legal regulators that even if not all the regulators are written into the text, it is possible on many different bases (references, legal system, etc.) to consider and use them. If in a contract or law some specific regulator is missing by accident, then usually several possibilities to replace it exist, such as by taking into consideration the law of obligations or traditions. A contract or law can be short, but still sufficiently intense due to juridical homeostatic regulation.

Each regulatory step is related to guaranteeing new constancy. In order to do this, on each level a new subsystem was introduced to the regulatory mechanism, which enabled the regulatory quality to be increased (more flexible, efficient, etc.), by which the subsystem introduced on the previous level was influenced, and the last one in return was used to influence the previous one, etc. For that reason the sequence of regulatory types is **successive**. This **sequence of qualitative genesis is continuous**; (developmental) steps cannot be skipped, as in this way the subsystem required for the step is not added. No subsystems can be missing from a certain level of the regulatory system, as the regulatory quality and regulatory power respective to the step would get lost. All this has been known in some cultures for thousands of years already. All the changes related to the existence or non-

existence of six regulatory subsystems are described, for example, by the Chinese Book of Changes' 64 hexagram stories (the specific version that is presented from the point of view of the ruler's son is well known) (Vahur, 2003).

On each level the regulatory system developed achieves a certain maximum level of efficiency and in order to increase it, i.e. to achieve a new level of efficiency, it is basically necessary to create a new regulatory system which would be in principle more perfect, by adding a new key subsystem. As it is necessary each time to add an invariant subsystem that is distinctive to that sublevel (for example, a backwards chain in order to go over to the fourth level), then it is a **logical development sequence**. This logic can be successfully used in development as the number of possible solutions decreases essentially.

Regulatory Generation in Broader Approach

A gradual development process takes place probably everywhere – in nature, cognition (that is part of nature), and creation. In cases of crisis it is necessary to take into use either by chance, trial-error method or consciously some more efficient type of regulation. Different kinds of qualitative development graduations can be found from several sciences, including psychology, for example. In Russian psychology, Jakov Ponomarjov's six creative stages of structural-dimensional creation theory (Ponomarjov 1976) and Lev Filonov's six contact establishing levels (Filonov 1992) can be referred to; in pedagogical psychology Niina Talyzina's six stages of acquiring (Талызина 2006). The ideas of qualitative graduation (Lev Võgotski's socio-cultural development, Pjotr Galperin's staged formation, Aleksei Leontjev's stages of identity formation, etc.) in the soviet cultural-historical psychological school are interesting.

Several of the aforementioned psychological studies have remained in regulation's last levels, in all regulation types and development's logical end undeveloped. The strict sequence based on stages development or efficiency is characteristic to all these approaches. The research in these studies has not originated from regulatory logic but from regulatory data's one characteristic outcome – describing the differences of emerging qualitative levels or development stages, examining empirical laws. But the internal regulatory causality that creates stages has remained undiscovered by them. It would be necessary to use in this case a formalised approach in examination of regulations, but this does not exist.

Using regulatory analyses would have potential in science. For example, in case of the theory of problem solving, called TRIZ, and the 36 Stratagems of Ancient China, the author has demonstrated attainable breakthrough based on a formalised approach (Вийк 2007a, 61–68, Вийк 2007b, 69–77). This methodology has been used in doctoral research in semiotics by Andres Luure (2006) in the form of sextets (six item structures) as the pervading primary structures of classifications and by Ivo Vahur (Vahur 2006) when examining historical rhythms. In the current paper, the author has chosen to analyze contracts and laws that have been previously examined by legal scholars.

As a rule, the researcher-authors of approaches presenting unfinished qualitative gradations have not methodologically explained which qualitative sequence they are dealing with regulative-wise. They have just found when interpreting their research results that this kind of gradual division is characteristic to research objects, but the question "why?" has not usually been presented. But if gradual sequences are analysed then the invariance of compiled gradations appears: with each step has been developed or differentiated, different from the previous, but always the following type of regulation. In analyses, when abstracted to regulative, these sequences correspond each time to **development's invariant stages sequence**, which could be named as quantitative genesis.

It can be stated that a **system's development takes place step-by-step through invariant regulatory stages**. **When reaching fully systematic status**, the further development can originate on the meta-level from the self-regulative system as the meta-element. As each level goes through a similar development on the micro level in turn, one can begin to speak **development fractality.**

No clear generalisation about the uniform gradual manifestations in different sciences has been managed to be made in **philosophy**. **Dialectic** uses a little developed gradual movement from concrete to abstract and vice versa, starting from the most simple primary cell until the completely developed body, through crossings, qualitative jumps, rolling together, etc.

After **cybernetics** and **system theory** evolved, fast-developing **synergetics** has now achieved the most in examining self-developing level sequences, but not even there have been managed to present integral invariant development sequence. In synergetics it could probably be demonstrated that regulatory types correspond to local optimums and that emergence of a sequence of different types of **homeostasis** together with fractal levels is in legitimate. The **postmodernist** statement about

the fragmenting of large narratives can be related to the parallel use of fractal regulatory forms and with the multiplicity of programmed optimums.

Classification of Law Regulators' Elements

As stated above, regulatory levels also exist in the texts of law regulators. Sophisticated regulatory systems such as laws and contracts contain elements expressed in words, which satisfy different regulatory functions. Especially in order to exercise regulation, the contracts and laws are phrased respective to specific regulatory elements and clauses. Within these a respective necessary regulation has been presented in words; for example, *law comes into force from n date* or *the contract penalty in case of delay in performing the contract is x dollars.* The regulatory power of a legal text comes from a combination of suitable regulatory elements needed to solve different problems. It is especially the multiplicity, difference and complexity of problems and issues to be solved that necessitates the use of legal regulators' different levels all possible regulatory types or complete fractality**.**

In the history of law it is possible to follow – in phylogenies or course of descent in relation to creating regulations for increasing the complexity of contradictions, learning to know them and solving these issues – the step-by-step development of fractal levels that involve the lengthening of text regulators. This in return creates indispensably another contradiction that has to be solved in ontogenesis or in individual text development – if before the help of a lawyer was needed to phrase a proper contract, then now also for finding important regulations from the text and for controlling their execution. To overcome this growing contradiction, one day there has to be a shift towards formalising texts. Summaries of the most important regulatory elements of long contracts and laws are already now used. **Regulatory analyses give to the practice, as one possible step, logical matrix tables of the elements of regulatory texts**.

For deconstruction it is necessary to know how language as a tool constructs different types of regulatory mechanisms. Analysing, for example, seemingly similar regulations in contracts, such as *"If payment is not received by the due date, the penalty is 0.1% per day"* and *"If payment is not received by the due date, the penalty is 1000 dollars*", then reveals the difference of these regulatory types. If payment liability is of a regulative **"yes-no"** type ("yes"), then not paying by the due date originates from the following or **range regulation**, wherein some

time range was agreed, i.e. the due date. Thirdly, it has been agreed upon in a **directly binding** regulator in one case to use the measure of 0.1% of the unpaid amount and in another case the amount 1000 dollars. Fourthly, the **backwards binding** regulator in the first example is the number of days that are unpaid; in the second one this is not regulated, because the retrogressive regulator is missing. The fifth and sixth regulatory subsystems are also missing. Hence it is possible here to **distinguish different types of regulatory elements**, respectively direct binding and backwards binding, which usually or in language have the established names of [4.] ***interest*** and [3.] ***contractual penalty***. This is the way subliminal regulatory elements are constructed from words. To know how it is not always necessary to be aware of it – when trying to deliver the algorithm of buttoning, tying shoelaces or sneezing. Analogically all other contract and law elements can be analysed to determine regulatory type.

When applying regulatory analysis in the science of law (2004, 2005) it turned out that **elements of legal regulation can be determined to perform some specific (cybernetic) type of regulation.** For example, in the element of law, coming into force is the simplest type of regulation. There is a possible changeover from no validity or "no" regulation to a "yes" type of regulation. *Interest* has, as a legal remedy, the function of controlling backwards binding, etc. Despite the fact that the person who constructed the regulation, when phrasing it, was not thinking about any specific regulatory cybernetic type, he has indispensably used one of these during this construction. From this arise some important conclusions:

1) **each element as a regulator has a specific cybernetic type,**

2) the type is determinable by regulatory analyses, and

3) elements are classifiable on fractal levels **based on types**.

In order to **disprove** these conclusions, to would be necessary to discover a regulatory element that cannot be classified. The imperfection of this classification system would also be demonstrated if an element could be classified as belonging to a seventh, thus far unknown, regulatory type.

As every regulatory element always has a certain type of regulation, these regulatory types can be identified in elements of legal texts, and clauses can be classified according to regulatory types, the sequence of regulations (genesis sequence) has been used with fractal levels in legal texts to classify all regulatory elements. This approach is not traditional in law, but dealing with different disciplines together or in an integrated manner has become common in science generally.

When determining each element's regulatory type, it is important to discover the regulatory type with the highest level that is performed by this element. Specifically, the highest regulatory capacity determines an element's efficiency and type. It has to be taken into account that each regulatory element belongs in turn to a higher level body which means that fractal levels have to be considered. Therefore, when classifying elements, their fractal level or position in the hierarchy has to be discovered. This is helped by their functional cohesion, i.e. all lower fractal level elements guarantee the functionality of the higher level element to which they belong.

In appendices 1 and 2 the elements of contracts and law are presented in a simplified form with keywords only **on two fractal levels or a two-dimensional table**, which forms a regulative field. In reality, at least in the case of contracts, the elements could be presented in a **five-dimensional regulatory space or on five fractal levels.** Additionally, it is possible to compare matrix tables one with another. It turns out that contracts and laws have a similar structure and several of the same-typed elements that are performing regulation have similar names. But the main difference between tables comes from law and contracts' own regulatory type, or regulatory main task. If the **law is primarily a** regulator **providing a direct link on the first fractal level, the contract provides feedback**. If a law gives a universal unilateral norm for regulation, then through negotiation between parties while drafting a contract or with a backwards-binding process, additional regulatory specifications are added. This principal regulatory difference is embodied in all the elements of both, on both of their matrix regulatory fields. Therefore, although on the second and third fractal levels the same types of regulations are performed in contracts or law, the difference already exists on the first fractal level. This is demonstrated in the nature of regulations and in semantics, in their somewhat different designations.

When examining different elements, in order to distinguish them formally, these elements should be **marked**, or indexed in some manner. A specific serial number of regulatory type that never changes can be used to index elements. An element can have many of these numbers according to developed levels. For example, on the third fractal level, the first numbers show through the types of mid-levels or 3.law, 3.3.norm and the last number shows the regulatory type of specific element – *3.3.4.sanction.*

Actually, the number of elements found in laws and contracts can be **much higher** than the one shown in the tables that are presented in the appendices. They

are not presented here, but one key term that is suitable for generalisations has been chosen from among synonyms and distinctness originating from adjustable situation. A large quantity of regulatory elements additionally exists from the fourth and fifth fractal levels, belonging to the subsystem, that are already developed or in the development phase. For example, these terms belong to the *4.3.4.legal remedies* on the fourth fractal level: *4.3.4.1.retreat*, *4.3.4.2.denunciation*, *4.3.4.3.lowering price*, *4.3.4.4.compensating damage*, *4.3.4.5.requiring meeting obligations*, *4.3.4.6.denying meeting obligations owed by oneself,* and on the fifth *4.3.4.4.3.contractual penalty, 4.3.4.4.4.fine for delay,* etc.

The elements are qualitatively different from one another on fractal levels. All the structural elements must exist on the second level in order to have a valid regulation. For example, the contract's *requisites as contract participants*, as well as *offer* and *agreement* and the contract has to be in force as an *application provision*, control possibility derives from law of obligations act and whereby internal regulators join automatically. **When** an **important element is missing, the contract structure collapses.** On the third level, elements may be missing, but they are hierarchically or functionally in sequence. Therefore on the **third level, each following element can be regulatorily efficient only when all the previous elements on this level exist**. For example, when some contract's *reciprocity* element or law's *norm element* is irreplaceably missing, then the next elements starting after this one can have no meaning even if they exist in the text. They are not able to exercise the necessary regulatory power because they each are dependent in the hierarchy upon the previous element and this essential hierarchical *"hanging dependence"* exists with each third level element. On the third fractal level, elements can be used independently from one another, **originating from achievable efficiency or backwards binding**. Previously such important differences between some elements have not been noticed or explained.

Forming a regulatory field of the elements of legal regulators is to some extent similar to the **efficiency field** that is offered by Uno Mereste in the complex analysis methodology of economics, where the most important economic indicators of the research object are related and the result is a table of efficiency ratios (1984, 1987). On the **regulatory field** it is also possible to follow the increase of efficiency of regulation performed and its step-by-step approach to self-regulation, in the table from top to bottom and left to right. Unlike efficiency fields, the formation of a fully systematic field has been chosen here with a complete classification sequence and guaranteed by fractal principles, which means that all possible third-fractal-level regulatory elements are in place.

Content in Words and Form

Regulatory texts are formed in phrasing based on cognition of composition, experience from practice, mistakes and the analyses of correcting mistakes. Additionally, when phrasing contracts or laws it can be difficult to be conscious about necessity in the regulated situation, what kind of regulatory situation is sought to be achieved. In *compensating damage* regulation, for example, it must be indicated when it is more suitable to choose a *contractual penalty*, *interest,* or some third form of regulation and then find suitable phrasing for that. Of course, it is necessary in choosing phrasing that it be possible to understand the **content** of what is said in a clear and precise manner. Besides content, the construction created by phrasing must be in accordance with chosen regulatory-type requirements, include respective mechanisms, and created with words exactly the respective type of regulatory situation. This phrasing must create a necessary regulatory **form**. The **form problems** of contracts, laws and their elements are more fundamental to guaranteeing applied phrasing clarity.

When phrasing laws and contracts it is possible to distinguish two parallel approaches that can be named as the content-related and form-related sides. The content-related side concerns concrete regulatory objects and their special features. For example, sales contracts and rental contracts are different when viewed from the content-related side, but their form can be similar. The form-related approach enables us to understand that laws are not only phrased, but that first of all they are formed, which means that the required regulatory form is given through words. Formulating elements originate indispensably and foremost from regulatory form, not from verbal form-wise fixing. **When the necessary regulatory form is known, then suitable phraseology can be found for it – not vice versa.**

Without knowing this or when using a trial-and-error method, the content has to be rearranged until it happens to have the required regulatory nature, then the clause starts functioning and regulating with the desired effect. This is, of course, if it has to do with text creation demanding creativity. I In a routine situation, it is sufficient for a lawyer to adapt some suitable contract template or analogue in law composition. When the message delivered with words includes as a construction the suitable regulatory type, then it is possible when acting in reality to efficiently use this regulatory type without noticing the type as such. This is how it has always been – in routine it can be managed without knowing the regulatory types and structures of legal texts. Creating fractal regulations is not often thought of as form creation; the regulatory types used are not distinguished this way. This,

however, does not mean that one cannot **become aware of something performed unconsciously, improve it into scientific method and communicate the principles of regulatory-fractal formal logic**.

Integrated Logical Structure of Law

In order to give a better illustration, **the structure of regulatory elements of an integrated text** can be compared **with Mendeleev's law.** Although the analogy is from a completely different field, it can still be basis for drawing some parallels. Analogically to Mendeleev's table, the thirty or so elements of contracts and laws found in the table in their only possible formological positions based on each element's qualitative features, forming an integrated system that is fully systematic. While in Mendeleev's table the elements' classification is based on their location on different electron layers and the resulting periodical occurrence, which in turn results in providing an opportunity to present elements in a table, then with law or contract elements a similar table can be compiled that is based on regulatory types and containing periodical occurrence.

This study subsequently shows how in a fully systematic approach, when taking advantage of matrix table emergence, the **missing elements** of a system can be found in analogical correspondence to Mendeleev's chemical elements table. **When originating from the synergy of the table's regulatory fields, the main regulatory features of the missing element can be predicted.** It is relatively easy to find in the analyses (see appendix 1) that the well-known elements of the **logical structure of a norm** – hypothesis – disposition – sanction – correspond to regulatory types 2, 3 and 4. A directly linking hierarchising measure and finally a controlling feedback are added to the range structure of something. What could be the entire sequence of a norm's logical structure? According to the applied classification logic, in a norm's logical structure the hypothesis must be preceded by the **first level regulatory single element, of which the main general feature is normative nature (directly binding on a general level), that in different specific legal situations either exists or not ("yes-no" regulatory form on a sublevel) and that should precede the *hypothesis* (second level regulatory type), being thereafter in the structure of the *hypothesis* the simplest component, because every following level includes the regulatory mechanisms of the previous levels.**

It was significantly easier to find this kind of delimited legal element or regulator from among many. This simplest regulator of legal norm is the ***legal fact.*** A

hypothesis consists of one or more *legal facts* that are linked between them. Therefore, a qualitative genesis sequence starts as an element of a legal fact, which thereafter together with other facts, in order to achieve a new regulatory quality, is connected to the hypothesis. Third, an agreed or dispositive evaluation is added as a direct binding regulator. The fourth regulator is a negative backwards binding one or ***legal fact – hypothesis – disposition – sanction*** -…

The sequence can be developed further. When violating disposition, a sanction is applied with the fifth type of regulator, with a programmed ***proceeding norm***, wherein the individual necessity and performance of changes in a violating activity as an aberrational program is decided. A complete logical sequence terminates with six regulators, that enact changes to the violating activity program through several parallel activities – **executing** punishment or incentive, preventions and if necessary re-socialisation and thereafter rehabilitation. Somebody who goes through the whole cycle is, according to the law's regulatory idea, supposed to be changed to be permanently law-abiding and fit into the social **homeostasis**. If not, the regulatory balance in society is violated again, and logically the cycle would be subject to increasingly rigid repetition. The contract also has its own analogical structure: price – payment condition – legal remedy or in case the price has been agreed upon in the purchase, then it has to be paid for according to the agreed terms, otherwise there is a sanction. Until now, there has been no approach that enables such a sequences' internal logic to be opened and the sequence of complete logic structures found.

The goal of using and developing legal regulators is to overcome potential conflicts through the use of regulation. Adequately drafted regulation should essentially decrease the emergence of tensions between parties or enable them to be overcome. More generally stated, it is a procedure wherein the goal is to improve regulation by using the existing useful resources, in conditions of limited resources. Each regulatory level has achieved a qualitative breakthrough to the next regulatory type by this performance, wherein despite increased processing costs, the use of regulation will turn out to be more efficient in the long run.

The regulatory text is grammatically steady and unalterable, but the life regulated by it is in constant change. Can this kind of text, as a static system, be a self-regulative system? If not, then this text should, from the moment of creation, be determined to be approaching alienation and extinction in the differentiating world. Proceedings-wise the efficient text must find its own internal environment or a self-regulative manner in the text to go along with the changes of the internal

environment, to adapt. Ideally (text-wise), a regulator is characterised even by its non-existence (written), but regulation takes place. How does a regulative text as a thought technology structure overcome this contradiction concerning time. A text can be called **self-regulative** in relation to internal environment, but it must have at least some of the following **features**:

- the text itself has regulators that help to control its proper usage; for example, in the law [3.4.]legal help and contract [4.4.] control elements;
- there are elements in the text that help to validate the text as a whole and change the form of validity
- there are elements in texts that help to validate the text as a whole and to change in a controlled way the validity of the text itself; for example, a law and contract have for that purpose[3.5., 4.5.]implementing provisions;
- to fulfil its tasks, a text includes elements, that use already existing or still-to-be-created regulators in the internal environment, like laws [36]in law creation and contract [4.6]elements in external regulators;
- some text regulators give homeostatically to the external environment regulators the right to flexibly consider continuously changing situations and in such dynamic conditions take an optimally regulative decision – in some cases to people themselves regarding laws [3.6.5.]giving discretionary authority and regarding contracts [4.6.5.]giving design rights;
- some of the regulators belonging to the text leaves intentionally something in life as in a process [3.6.6.]to be worked out and [4.6.6.]enacted, forming itself into a suitable regulator in practice and to change together with the development of external environment – like in laws and contracts [3.6.6.,4.6.6.]regulations that are considered reasonable.

Therefore, people can provide content to the regulatory text with such elements that include the participation of these people and society in the regulatory process, which means **there is no directly dictating regulatory text, but regulation nevertheless takes place.** Using this kind of **homeostatic** regulation, the static verbal regulator actually becomes self-regulative, dynamic processes, which is vital when overcoming contradictions. The self-regulative nature of regulations is shown most expressively in that people normally do not even notice that they are acting in accordance with laws or contracts. The existence of optimally written laws and contracts as frames is not noticed, until relations have become complicated, carry over the frames and when regulatory help outside the text is needed for smooth co-existence or recovery of cohesion. Therefore, text of the proceeding is as a rational achievement of the social system, the (only) necessary facility to re-establish self-regulation in life.

Summary

In such simple and widely used legal regulators as contracts and law can principally, when using a new research method, be distinguished unexpectedly complicated and nice internal order. It appears that in seemingly loosely phrased contracts and law something else besides words is also hidden which is hardly distinguished – from a hidden and very rigidly organised fractal structure and a hierarchy of regulatory elements. Until now, little attention has been paid to the different types of regulations in use. Contract clauses have not been classified according to regulation types or classified into a regulatory matrix. For the first time, something which combines elements into a whole and which until now has been elusive and incapable of articulation, is beginning to unveil itself. It becomes understandable why and how the clauses form an entire uniform system, contract or law.

If one could think that in a contract or law a behaviour manual for endless different unrepeated situations is written, then it now becomes clear that these types of situations are supremely organised. In legal texts the action is performed in a causally sublime way, using trial-and-error method in the diversity of the whole world of possibilities with suitable regulations organised from "wall to wall". The coincidental and unavoidable have unnoticeably met when drafting regulations and found expression in words and form. The infinity of concreteness has been clapped together on the formalised logical level into fractal regulatory types. A goal-oriented and causality understandable process can be added to the creation of intuitive, experiential and casuistic legal texts, where the created can, in case of necessity, be raised to consciousness.

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Appendix 1. Personal Data Protection [3.]Act regulatory structure in short table

Regulatory Type	[1.]Yes/no	[2.]Range	[3.]Direct Binding	[4.]Backwards Binding	[5.]Program	[6.]Homeostasis

[3.1.]Requisite Information

Heading	Signature	Pronouncement	Publishing	efinitions	Principles
Personal Data Protection Act	Chairman of the Parliament Toomas Varek and Ene Ergma	President of the Republic 07.03.2007 decision no. 127 and 12.12.2007 no. 218	RTI 16.03.2007 24, 128 Changed: RTI 06.12 2007 68, 421	§4 §5 §7 §8 §9	§6

[3.2.]General Provisions

Regulation Field	Resources	Objectives	General Requirements	Proceeding	Adaptations	Ambit
§1lg2	§4lg2	§1lg1	§7	§2lg2	§2lg1,3	§3

[3.3.]Norms

Facts	Hypothesis	Dispositions	Sanctions	Proceeding norms	Execution
§31	§§10-21 §§24-30	§§10-21 §§24-30	§42 §43	§12 §13 §29 §44	§29lg3,4

[3.4.]Legal HQ

Controllers	Tasks	Reaction	Informing	Legal Remedy Norms	Financing
§32 §34	§33 §37	§39 §40	§38lg2 §41	§22 §38	§23 §40lg2

[3.5.]Implementation Provisions

Enactment Norm	Alterations to Invalidity	Transmission	Provisions	Alteration Deadlines	Implementation Differences
§73	§46	§§47-72	§45	§45	§33lg5

[3.6.]Enactment

Conflict Norms	Reference Norms	Competence Norms	Authorisation Norms	Consideration Norms	Developing
§7lg3 §10lg1 §11lg4,8 §12lg6 §24lg1	§2lg3 §12lg7 §15lg2p3 §33lg2p5 §35lg2	§16lg3 §18lg3 §35lg4 §36	§10lg3 §31lg5	§11lg2,3,7p2	§25lg2p7

Norm technical note

Appendix 2. Regulatory Structure of [4.]Contract on Two Fractal Levels

Regulatory Type	[1].Yes/No	[2].Range	[3].Direct Link	[4].Feedback	[5].Programme	[6].Homeostasis
[4.1.]**Requisite Information**						
	Designations	Contract Parties	Confirmations	Bases	Definitions	Principles
[4.2.]**Promises**						
	Objects	Quantities	Obligations	Quality Requirements	Deliveries	Warranties
[4.3.]**Reciprocities**						
	Returned Promises	Prices	Payment Terms	Legal Remedies	Payment	Collateral Guarantees
[4.4.]**Controls**						
	Control Organs	Control Measures	Reactions Notification	Obligations	Complaining Rights	Execution Controls
[4.5.]**Implications**						
	Enactments	Exclusions	Alterations	Pre-Deadline	Endings	Force Majeure
[4.6.]**External Regulators**						
	Validity	References	Experts	Authorisations	Design Rights	Non-Enacted

Application of EU competition law to the sports sector

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In 2004, sports generated value-added of 407 billion euros, accounting for 3.7% of EU GDP, and employment for 15 million people or 5.4% of the labour force (European Commission White Paper on Sport 200, ch. 3).

PART I: GENERAL CONTEXT IN WHICH LEGAL REGULATION TAKES PLACE

Commercialisation and juridification of the sports sector

Changes in the structure of the demand market for sports broadcasting over the past two decades have transformed the face of the sports industry forever. Namely, the broadcasting sector used to be characterised by the presence of only a few players on the market. In the 1980s there were four commercial TV operators in the whole of Europe (Collins 1994, 146). The decartelisation of the broadcasting sector and the emergence of an increasing number of operators as well as the advancements in mass media technology have brought about a fierce competition for the broadcasting rights of sports events, thus skyrocketing their value.

For example, when the live transmission of English league football matches began in 1983, the BBC and ITV duopoly acted collusively in order to purchase the rights to two seasons at a deflated value of GBP 5.3 million (Massey 2007, 88). In comparison, the current three year broadcasting contract with BSkyB for the matches of the English Premier League is valued at GBP 1.7 billion.[1] Similarly, acquisition of rights to the 1990, 1994, and 1998 Football World Cup matches cost the European Broadcasting Union cartel USD 240 million. The contract for the same event for 2002, 2006, and 2010 saw a 900% increase in the value of the rights, which were purchased at a cost of USD 2.36 billion by the Kirch Group (Hoehn and Lancefield 2003, 555).

The more exposure the sports events had in the media, the more interest and value they also had for the sponsors. According to the European Sponsoring Association

[1] Source: BBC News available at http://news.bbc.co.uk/2/hi/business/6273617.stm

(ESA), in 2005, 91% of all sponsorship deals went into sports. The value of the world sponsorship rights rose by $25 billion between 1990 and 2000.[2] In Formula One motor racing this means that over 100 sponsorship logos will flash before the eyes of a 1.9 billion worldwide audience who follow the 17 or 18 annual F1 races. Sponsorship brought EUR 664 to the F1 11 teams in 2006, and the six major car manufacturers invested over a billion euros into their teams.[3] As has been said many times already, sports has become 'big business'.

This sharp increase in commercialisation of the industry was followed by juridification, a term used to describe the process by which sports leave the safe zone of internal self-regulation and become subject to ordinary laws. Attention of legal regulators was caught *inter alia* by the ability of the industry to profoundly affect the competition in and the structure of downstream markets (such as, for example, the broadcasting market, ticketing market, etc.) and to affect the commercial interests of the clubs and athletes.

The purpose of this article is to present the way in which the well-established rules of EU competition law and policy apply to the sports industry. Selected rules of the sports governing bodies will be placed in the context of EU competition law as enforced by the European Commission (the Commission) and as interpreted by the European Court of Justice (ECJ or the Court). Because European sports law has a heavy football and Formula One focus[4], they will be the most common point of reference. However, before turning to this discussion, we must consider a few preliminary points concerning the specificities of the industry and the organization of sports in Europe.

European Model of Sports

Sports in Europe are typically organized in a pyramid structure. At the bottom of the pyramid are the amateur, semi-professional, and professional clubs that play in various leagues according to their sporting achievements. They are all members of the national federations for their particular sport. National federations organise competition and regulate the sport in question at the national level, and represent

[2] A study conducted by Q&A Resources Ltd available at http://www.qaresources.co.uk/samplebus/standalone/Sponsorship.pdf

[3] Source: CNBC European Business available at http://www.cnbceb.com

[4] This is understandable as they are the most lucrative of all the European sports and able to affect the structure of the market most profoundly.

their branch at the European and international level. European governing bodies are at the apex of the structure. Only one federation per country can be a member of the European governing body.[5] In addition, there are also world governing bodies to which the national federations belong. European and other regional bodies support and share the organisation of the sport with the world federation.[6]

Organisational structure of sports in Europe

The described structure reveals the apparent monopolistic position of the governing bodies. They are able to pass the rules and regulations which affect the way in which clubs buy and sell players, dispose of their commercial rights, conduct themselves on the stock market, and impose disciplinary sanctions which in turn affect the clubs' profits, and so on.

In European sports, clubs are able to move up and down in the leagues depending on their on-pitch performance. If a club is successful, it can pass to play in the higher league; and conversely, if a club constantly underperforms, it can fall into the lower league.[7] This is not incomparable to the competitive 'ordinary

[5] European Model of Sport, Consultation Document of DG X, European Commission.

[6] In football, this would translate into clubs such as, for example, FC Milan being affiliated to the Federazione Italiana Giuoco Calcio (Italian football federation) which organizes and manages the game of football in Italy from all levels of clubs to the national teams and which is affiliated to Union of European Football Associations (UEFA). UEFA has 53 such member national associations. The world governing body for football is International Federation of Football Association (FIFA). FIFA regulates matters and organizes events that have worldwide importance. 6 continental federations and 208 national federations are currently affiliated to FIFA.

[7] The best performing football clubs in the highest national league are qualified to play in the UEFA Champions League. Every European country has a space for at least one club. The number of places in the competition depends on the association's rank in the UEFA coefficients table.

markets' in which undertakings operate, notwithstanding the lack of formal league structure.[8]

Specificities of the industry

Preliminary remark

A lot of academic and policy discussions thus far have focused on the question of 'whether sport is special.' I submit that it is time to dispose of this outdated question. Asking 'is sport special?' implies that it might possess inherent justification to restrictions to the operation of internal market and undistorted competition, or that it could be exempted altogether from legal regulation by some other token, and thus gives a wrong spin to the ensuing debate. Not once in the ECJ jurisprudence was there an indication that this interpretation might hold to justify either the wording or eagerness with which the question is asked. Today we know better – sport is not special! Nevertheless, much like certain other industries, sport does have its specificities and special characteristics which need to be taken into consideration when applying the law. Therefore, the discussion should be reconceptualised and the question refocused on specificities of the industry which distinguish it from other industries and the significance those specificities possess when applying ordinary laws to sports.[9]

Apart from the system of promotion and relegation described above, I will now outline some of the other key characteristics of the sports sector. First, mutual interdependence between the clubs fostered by the need to preserve uncertainty of results is a truly distinctive feature not possessed by any other industry. It is not the purpose of the clubs to eliminate their competitors. The product of a certain league is the game, and the game must be interesting in order to attract the audience. The more equal are the competitors, the more uncertain are the results, and the more interesting is the game.[10]

Second, the need to maintain the competitive balance is an excuse for financial solidarity mechanisms that exist in the distribution systems of the most profitable

[8] System of promotion and relegation can be contrasted with the US model of sports where the leagues are closed for its members who are nothing more than league's franchisees. They cannot fall out of the league or be promoted.

[9] This is in line with the Court's jurisprudence in C-519/04 *Meca-Medina* (discussed below) and the general case-by-case approach.

[10] Scientific evidence on this varies as some researches suggest that the game is to be more visited when the home team has two times more chances of winning.

leagues.[11] To illustrate, a club's participation in the league is often conditioned upon the transfer of the broadcasting rights to the league, which after collectively selling the rights thus acquired, distributes the profits to the participating clubs with a view to ensuring the competitive balance. In no other industry would companies share a part of their profits with a less well-off competitor.[12] Vertical investments and support for social causes, however, can find its parallels in other industries, albeit on a more voluntary and calculated basis.

Third, sports have a transient nature which is multifaceted: individual sportspersons' careers are short and prone to many interruptions, even abrupt endings due to injuries. Sports broadcasting must take place as the event occurs, sports betting is a time-restricted game of chance, commercial exploitation of, for example, certain sports merchandise is limited to short period in which the theme affixed to the item is popular, live attendance at the stadiums is a one-time-and-never-again occasion, and so on.

Fourth, as recognised by the ECJ in the famous *Bosman* jurisprudence[13], sport (football, *in casu*) performs an important social, cultural, and educational function. This approach of European regulators is confirmed by the inclusion of sports into the framework of Article 149 EC Treaty, as amended by the Lisbon Treaty, as well as by numerous policy documents. It is exactly this aspect of sports that provides the most leverage to the socio-cultural coalition pushing for more autonomy of sport bodies within the EU legislative/policy development process[14] and that underpins some of the objective justifications accepted as such thus far.

Finally, specificities built into certain aspects of sports confer on them substantial but not unlimited exemption from the application of ordinary laws. This is the most obvious in the application of criminal laws. Namely, hitting and injuring another person is allowed in combat sports (such as boxing) and might win a match rather than time in prison[15]; use of illegal drugs will subject sportspersons to sporting sanctions such as

[11] There are vertical and horizontal solidarity mechanisms: former implies financial solidarity between professional and amateur leagues and clubs, financing of the various social causes, infrastructure, etc. The latter implies financial solidarity between clubs in the same league.

[12] This is not to say that commercially most successful clubs are happy with the distributional solidarity system. See the discussion on 'breakaway structures in sports' *infra*.

[13] Case C-415/93*Union Royale Belge Sociétés de Football Association and others v. Bosman and others* [1995] ECR I-4921.

[14] For more on conflict between advocacy coalitions see Parrish, Richard. "Sports Law and Policy in the European Union" UK: Manchester University Press, 2003.

[15] See, however, Ian Blackshaw 'Jail Players Who Commit Dangerous Tackles' The International Sports Law Journal, No. 1-2, 2008, for the discussion on criminal sanctions for players.

prohibition to compete for a certain period of time rather than to criminal proceedings. Similarly, normal labour laws do not apply to 'workers' such as players in football clubs. Their profession is still regulated differently.[16] A number of other regulatory and disciplinary aspects are left entirely in the hands of sporting authorities.

These are some of the most distinctive features of the sector. Later in the article[17] it will become clear that it is in this context and against this background that the examination of any rule of sport bodies under EC competition law should be conducted.

Legislation, regulators, and regulatory challenge

The balance between the law and policy is crucial in this area. On the one hand, the Community does not have direct legislative competence to regulate sports. The traditional instruments are therefore used to protect the core objectives of the Community when the rules and activities of sporting bodies obstruct the functioning of the internal market and distort competition.[18] On the other hand, there is a growing number of non-binding (soft-law) policy statements on sports which articulate the direction in which the Community is heading.[19] They provide an impetus for the development of principles for the enforcement and interpretation of traditional rules in this regulatory environment.

Primarily, however, sport should be viewed as an activity subject to internal self-regulation. The autonomy of a sport to govern itself is important and should be preserved. Sports federations are the best placed authorities to set the rules of the game, set the system of disciplinary sanctions and appeals, establish special dispute

[16] A distinct but related topic to this article is the application of internal market rules on freedom of movement for workers and self-employed professional to the rules of sport bodies governing the players' contracts. For instance, transfer of players between clubs, contractual ties (*Anelka* and *Webster* type of problem), as well as the 'home-grown' rule on fielding the players are a part of the debates on this topic.

[17] See the paragraphs below on *Meca-Medina* case.

[18] Such as EC Treaty rules on competition in Articles 81 and 82 of the Treaty, as well the Treaty rules on freedom of movement for workers (Article 39), self-employed (Article 43) and services (Articles 49 and 50). Secondary legislation is limited and not directly related to sports. It includes documents such as new Audio-Visual Media Services Directive **2007/65/EC, Directive 96/9/EC of 11 March 1996 on the legal protection of databases** *OJ L 077, 27/03/1996* and Environmental Impact Assessment Directive 85/337/EEC, as amended.

[19] Such as Nice Declaration, Amsterdam declaration, Helsinki Report and most notably, Commission White Paper on Sports available at http://ec.europa.eu/sport/index_en.htm

resolution bodies, design codes of conduct on and off the pitch, and decide on other matters that concern organisational and regulatory aspects of their respective disciplines. Thus, a strong argument exists to keep sports out of courts (but also away from interference by legislators).

The internal self-regulation will be scrutinised every time that the activity or the rule of the sporting bodies affect the proper functioning of the internal market. Put simply, self-governance is not unlimited. The regulatory challenge is therefore to find a proper balance between the sporting autonomy and legal regulation, between the need to preserve legal certainty for sport bodies and the need to protect the undistorted competition in the internal market. The European Commission, as an institution charged with enforcing the EC Treaty rules, will inquire and, if necessary, open up formal proceedings against suspected cases of infringements. Their decisions may be appealed to the Community Courts under Article 230 of the Treaty. The case may also reach the Community Courts *via* preliminary reference procedure under Article 234 of the Treaty.

Having set the foundations for understanding of the paragraphs that follow, I shall now turn to the core of this paper.

PART II: EU COMPETITION PROVISIONS AS APPLIED TO THE SPORTS SECTOR

Elements of Articles 81 and 82 of the EC Treaty

Community competition law refers to the activities of undertakings and, more specifically, Article 82 EC applies to undertakings holding a dominant position. Any entity engaged in an economic activity,[20] irrespective of its legal form and the way in which it is financed, is categorised as an undertaking .[21] Provided that

[20] Any activity consisting in offering goods or services on a given market is an 'economic activity'. See, in particular, Case C-35/96 *Commission* v *Italy* [1998] ECR I-3851, paragraph 36, and Joined Cases C-180/98 to C-184/98 *Pavlov and Others* [2000] ECR I-6451, paragraph 75. In addition, in Case C-222/04 *Cassa di Risparmio di Firenze and Others* [2006] ECR I-289 (paragraphs 122 and 123), the Court stated that the fact that the offer of goods or services is made without profit motive does not prevent the entity which carries out those operations on the market from being considered an undertaking, since that offer exists in competition with that of other operators which do seek to make a profit.

[21] Case C-41/90 *Höfner and Elser* [1991] ECR I-1979, paragraph 21, and Joined Cases C-264/01, C-306/01, C-354/01 and C-355/01 *AOK Bundesverband and Others* [2004] ECR I-2493, paragraph

this condition is satisfied, the fact that an activity has a connection with sport does not hinder the application of the rules of the Treaty[22], including those governing competition law.[23]

Furthermore, it has been specifically recognized that: national and international sporting associations, clubs, and independent athletes can constitute 'undertakings'[24]; sporting federations can in addition also constitute 'association of undertakings';[25] their rules can amount to 'agreements or decisions'[26], distort the competition on the relevant market, and affect trade between Member States within the meaning of Article 81.[27] Sporting federations are undertakings in a monopolistic position[28] and clubs can be collectively dominant within the meaning of Article 82.[29]

An element that Article 81 and 82 have in common is *inter alia* the need to define the relevant market from both geographic and product market point of view.[30]

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[22] In the context of EU internal market rules see for eg. Case 36/74 *Walrave and Koch* [1974] ECR 1405, paragraph 4, and C-415/93 *Bosman* [1995] ECR I-4921, paragraph 73.

[23] Case C-519/04 P *Meca-Medina and Majcen* v *Commission* [2006] ECR I-6991, paragraphs 22 and 28, and C-49/07 *MOT.O.E.* (judgment of 1 July 2008).

[24] Case C-171/05 *Laurent Piau v. Commission of the European Communities, Fédération Internationale de Football Association (FIFA)* [2006] ECR I-37. Also see Commission decision of 25 June 2002 in Case 37806, *ENIC/UEFA*, para. 25, available at http://ec.europa.eu/competition/antitrust/cases/decisions/37806/en.pdf, Opinion of Advocate General Lenz in *Bosman* points 255 et seq. For individual athletes see joined Cases C-51/96 and C-191/97 *Christelle Deliège v. Ligue francophone de judo etc.* ECR 2000 I-2549, paras. 56 and 57. For international associations see Commission decision *1990 World Cup*, *supra*, para. 47 (for FIFA).

[25] See, Case T-193/02 *Laurent Piau v. Commission*, judgment of 26 January 2005, para 72. They also can constitute 'association of associations of undertakings' *e.g.*, Commission decision in case COMP/C 2-398 *UEFA, decision of 23 July 2003.*

[26] Case T-193/02*,* para. 75. Rules drawn up unilaterally by sporting associations consisting of undertakings will usually constitute decisions by an association of undertakings (see, *e.g.*, Commission decision *ENIC/UEFA*, para. 26, for a rule drawn up by the UEFA Executive Committee and C-519/04 P *Meca-Medina,* para. 45 for a rule drawn up by the International Olympic Committee and implemented by the International Swimming Federation).

[27] For general guidance see "Guidelines on the effect of trade concept contained in Articles 81 and 82 of the Treaty", OJ 2004 C 101/7. Rules adopted by international sport associations will normally affect trade between Member States. Rules of national sport associations usually concern a sport in the whole territory of their Member State and in light of today's high level of internationalisation of professional sport, rules adopted by national sport associations may often affect trade between Member States.

[28] Case T-193/02, para. 115.

[29] Case T-193/02, paras. 113-114; also see AG Opinion in *Bosman* para. 285.

[30] See Commission Notice on the relevant market, OJ C 372, 9.12.1997, p. 5–13.

Definition of the relevant product market for sports is a topic in itself, but it should not detain us for long. Suffice it to say for the present purposes that it can be of three types. The first is the exploitation market in which clubs and federations exploit their commercial rights, for example, through sales of broadcasting rights, ticketing, and merchandising. The second is the contest market in which the final product, the game, is made. In order to effectively stage a game, sports governing bodies design the rules that regulate competition between participants and rules limiting access to competitions. The third is the supply market which essentially comprises of buying and selling of players by the clubs.[31] Product substitutability is generally quite low in the first two types mentioned, but it is equally low when it comes to the top players in the supply market.

A sporting rule that is found to restrict the freedom of action under Article 81 or 82 may not breach those provisions to the extent the rule in question pursues a legitimate objective and its restrictive effects are inherent in the pursuit of that objective and are proportionate to it.[32] On this level of analysis, the ECJ takes into consideration specificities of sports as described *supra*. Under Article 82 it is possible that the restrictive rule will be objectively justified. With regard to Article 81, the third paragraph sets forth four cumulative conditions for exemption of restrictive rules making their effects a subject to complex economic assessment. **The balancing of pro and anti-competitive effects will be crucial to the outcome of the analysis.**

Selected issue #1: The Court's jurisprudence in the *Meca-Medina* case

Factual background

The first time that the ECJ directly addressed the application of competition provisions to sports was in the *Meca-Medina and Majcen* judgment of 2006.[33] The case involved two professional swimmers who were found to have breached the

[31] Classification according to A. Egger and C. Stix-Hackl, "Sports and Competition Law: A Never-Ending Story?" (2002) ECLR 23, p 86.

[32] Case C-519/04 *David Meca-Medina and Igor Majcen v. Commission* [2006] ECR I-6991. See also White Paper on Sports, para. 2.1.2.

[33] Case C-519/04 *Meca-Medina*. Before this case the ECJ has had a number of opportunities to clarify the relation between competition law and sports (notably in *Bosman*) but it has avoided this problem by deciding the case on the basis of internal market rules. In the absence of Community legislative competence, it was only the Commission decisional practice that shed some light on the competition law issues in sports.

sport's anti-doping rules adopted by the International Olympic Committee. They tested positive for nandrolone and were suspended for a period of four years by the Doping Panel of the International Swimming Federation that implemented the rules for their discipline.[34] Contesting the anti-doping rules, the applicants asserted that the rules were in breach of Articles 81 and 82 and that the penalties imposed were disproportionate.

Judgment

The ECJ started off by reiterating the orthodox rule from *Walrave and Koch*[35], a case decided in the context of the internal market:

> 'the practice of sport is subject to Community law only in so far as it constitutes economic activity within the meaning of Article 2 of the Treaty'[36]

Thus, rules of 'purely sporting' interest that have nothing to do with economic activity are excluded from the scope of the Treaty.[37] However, in the following paragraphs the Court has severely limited the scope of the sporting exception in *Walrave and Koch*:

> 'the mere fact that a rule is purely sporting in nature does not have the effect of removing from the scope of the Treaty the person engaging in the activity governed by that rule or the body which has laid it down.'[38]

This implies that when the specific sporting activity falls within the scope of the Treaty, the rules which govern that activity may be examined for their compatibility with the internal market and competition provisions. The safe zone created by the notion of sporting exception in which they previously operated has been significantly reduced.

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[34] The appeal against the suspension was first launched before the Court of Arbitration for Sports which confirmed the decision of the doping panel but later when scientific experiments showed that nandrolone's metabolites can be produced endogenously by the human body at a level which may exceed the accepted limit when certain foods have been consumed, they reduced the sanctions to two years. In 2001, however, the applicants launched the complaint with the Commission whose decision they appealed to the CFI and finally the decision of CFI was brought before the ECJ.

[35] Case 36/74 *Walrave and Koch* [1974] ECR 1405, paragraph 4. This paragraph was subsequently confirmed in Case 13/76 *Donà* [1976] ECR 1333, paragraph 12; Case C-415/93 *Bosman* [1995] ECR I-4921, paragraph 73; Joined Cases C-51/96 and C-191/97 *Deliège* [2000] ECR I-2549, paragraph 41; and Case C-176/96 *Lehtonen and Castors Braine* [2000] ECR I-2681, paragraph 32).

[36] Para. 25 of the judgment.

[37] Such as rules of the game. This could be, for example, a rule on the size of the field or offside in football.

[38] Para. 27 of the judgment.

The ECJ has thereafter set aside the reasoning in the decision of the CFI by finding the error in the interpretation of law. It held that:

> 'even if those rules do not constitute restrictions on freedom of movement because they concern questions of purely sporting interest and, as such, have nothing to do with economic activity, that fact means neither that the sporting activity in question necessarily falls outside the scope of Articles 81 EC and 82 EC nor that the rules do not satisfy the specific requirements of those articles.'

Therefore, the rules found to be purely sporting for the purpose of freedom of movement provisions, are not by the virtue of that fact also excluded from the assessment under competition provisions. They have to satisfy the requirements of both sets of Treaty rules separately. Finally, the Court turned its attention to the application of Article 81(1):

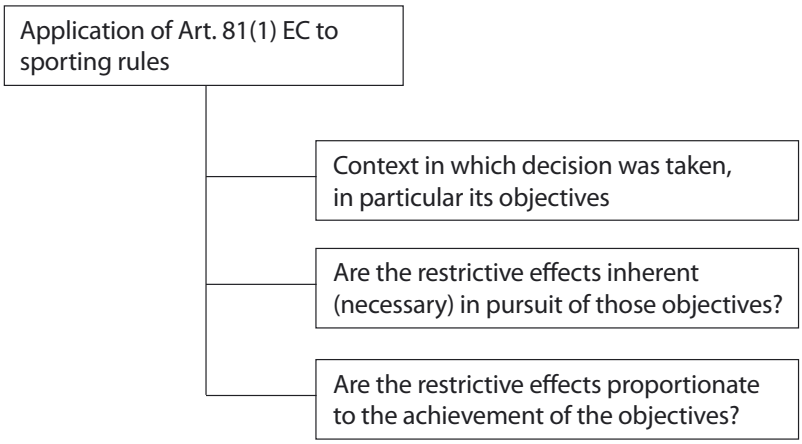
> 'Not every agreement between undertakings or every decision of an association of undertakings which restricts the freedom of action of the parties or of one of them necessarily falls within the prohibition laid down in Article 81(1) EC. For the purposes of application of that provision to a particular case, account must first of all be taken of the overall context in which the decision of the association of undertakings was taken or produces its effects and, more specifically, of its objectives. It has then to be considered whether the consequential effects restrictive of competition are inherent in the pursuit of those objectives (*Wouters and Others*, paragraph 97) and are proportionate to them.'[39]

Relying on its previous ruling in *Wouters* (which had nothing to do with sports) the Court emphasised the need for a contextual approach. The fact that the doping rule was intended to safeguard the objective of fair play and ethics in sports did not remove it from the scope of competition rules; the economic effects that it produces had to be considered in the light of the inherency tests and the requirement of proportionality. The rule was found to restrict athletes' freedom of action, but as the general objective was to provide a level playing field and preserve the integrity of sporting competition and the sanctions were necessary to ensure compliance with the doping ban, the restrictions were deemed inherent in the rule. The Court also found that athletes have not demonstrated that the rule was disproportionate and upheld the previous finding of the Commission on this point.

So the athletes lost. Of particular importance for understanding of the development of law in this field is to remember that they did not lose because the rules were of

[39] Para. 42 of the judgment.

'purely sporting' interest, but because these rules satisfied the test laid down by the Court in paragraph 42 (Whatherill 2008).



Flowchart under paragraph 42 of C-519/04 Meca-Medina and Majcen [40]

Comment

1. Needless to say, the judgment was not welcomed by the sporting bodies. In particular, the International Olympic Committee (IOC) and the two largest football governing bodies (FIFA and UEFA) saw it as an attack on their authority and an unnecessary intrusion into the scope of sporting autonomy that existed thus far. *Meca-Medina* has brought to an end the constitutionally based distinction in paragraph 4 of *Walrave and Koch*, leaving the sporting exception applicable to only a small number of rules which, in all probability, no athlete or club would even think to challenge.[41] UEFA's Director of Legal Affairs commented on the judgment in Meca-Medina saying that:

> 'it is not difficult to see how the position adopted by the Court may still open up a "Pandora's box" of potential legal problems. For a start, almost any sports disciplinary measure for any offence (e.g. doping, match-fixing, gambling, bad conduct, etc) might be described as representing a condition "for engaging in" sporting activity (in the sense that such measures may restrict somebody from "working"). Thus, all disciplinary measures (especially those imposing significant penalties) could, it seems, now be susceptible to challenge under EU competition law.' [42]

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[40] Case C-309/99 *J.C.J Wouters, J.W. Savelbergh, Price Waterhouse Belastingadviseurs BV v. Algemene Raad van de Nederlandse Orde van Advocaten* [2002] ECR I-1577.

[41] See footnote 42 *supra.*

[42] Infantino, Gianni. 'Meca-Medina: A Step Backwards for the European Sports Model and the 'Specificity of Sport?' UEFA Statement (October 2, 2006).

Speaking for the Financial Times, the IOC president Jacques Rogge expressed his concern:

> 'The judgment of the *Meca-Medina* case is a bit frightening for us… It puts doping under the competition rules of the EU. We have had established doping rules for a long time. We know proportionality of sentences is an issue, and we accept that. But we don't know why the EU should come in.'[43]

On the other side of the argument is the fact that the rule's being scrutinised under the competition provisions does not mean that it will be found in breach of those provisions. But the concern of the sport bodies seems to be there regardless of this fact. The case has opened a door for the possibility to challenge most sporting rules, and there will be a consequential increase in the number of litigations. Could it be that the ECJ is constructing a familiar environment in the initial stage of the enforcement in which they formulate the scope broadly so as to encompass most of the sporting rules, and could it be that this broad approach will later, when the sufficient body of law is established, be narrowed (i.e. specified)?

2. A separate comment may be made regarding the way that the Court had structured the analysis under Article 81, for it had conducted rule of reason analysis in the first paragraph of Article 81 when such considerations are more appropriate to carry out in the framework of the third paragraph. In the first place, the alleged restriction will be subject to objective justification under Article 81(1) as provided for in paragraph 42 of *Meca-Medina*. If the rule is found to breach that paragraph, it will then fall for economic assessments under the third paragraph of the Article 81. In a way, this gives a double possibility to establish compatibility. The application of law throughout the article will be additionally alleviated by taking the due account of specificities of the industry and the peculiar demands of sport governance. A number of policy statements[44] support the need to preserve specificities of sports and provide for soft application of law in this sector. The question which remains unanswered relates to the burden of proof under Article 81(1) in the framework of the *Wouters* test as absorbed by *Meca-Medina* in sport related cases. Normally, in first paragraph the burden is on

[43] Olympic Chief Fears EU Grip on Doping October 17, 2007 Financial Times Interview by Roger Blitz in London available at http://www.ft.com/cms/s/0/9efbeedc-7cf3-11dc-aee2-0000779fd2ac.html?nclick_check=1

[44] See for example, Report from the Commission to the European Council with a view to safeguarding current sports structures and maintaining the social function of sport within the Community framework *The Helsinki Report on Sport* Brussels, 10 December 1999 COM(1999) 644 final, and Presidency Conclusions, European Union Sport Directors Meeting, Lisbon, 12-14 July 2007.

the party alleging infringement and in the third paragraph on the defendant, but we will revisit this later.[45]

3. An unclear relation between the competition and internal market provisions of the Treaty is a prominent question in sports cases. To what extent and under which conditions can we draw the analogy from one to another area, whether objective justifications recognized as such for the purposes of internal market rules can be transplanted to the area of competition law, or under which set of rules is the case to be first examined when having implications for both areas, is still, after 60 years of the existence of the Community, an obscure matter. In *Meca-Medina* the ECJ has set aside the CFI decision and replaced it with a paragraph it pulled out of a hat. The UEFA lawyer commented:

> '[…]it is important to recall that the European Court of First Instance reasoned that if a sports rule was "non-economic" in character (and so outside the prohibitions of free movement law) then logically the same rule would be outside the prohibitions of competition law as well. It is submitted that there is a powerful logic to this position, stemming from the fact that the EC Treaty itself only applies to "economic activities" within the meaning of Article 2 (an approach that goes back to *Walrave*). Consequently, if a sports rule is "non-economic" in character the Treaty (i.e. all of it) does not apply and that is the end of the matter. However, in what can only be described as a strange twist, the ECJ held that even if a sports rule has nothing to do with economic activity for the purposes of free movement law, that conclusion did not necessarily mean that the same rule has nothing to do economic activity for the purposes of competition law. In other words, the Court appears to contemplate that a sports rule could be "non-economic" (and outside the scope of free movement law) but could nevertheless infringe Articles 81/82, despite the fact that these latter Treaty provisions are only concerned with the economic relationships of competition. It is very difficult to find logic in this.'[46]

Weatherill, on the other hand, has seen the setting aside of the CFI judgment not as a criticism of the convergence thesis but as the ECJ's first pointing out the inadequacy of the CFI analysis and then putting the interpretation of Article 81 on the right track setting the convergent course for other economic law provisions in the Treaty that affect sport (Wheatherill 2006, 645 et seq). Although this interpretation at first glance might appear to go against the express language of the judgment, I find it objective. The ECJ has merely reminded us that the two sets of provisions protect

[45] *Infra*, when discussion application of the *Meca-Medina* test on breakaway structures in sports.

[46] Infantino, Gianni. UEFA Statement (October 2, 2006) cited *supra*.

different freedoms of action and include different elements in analysis, and that those differences deserve recognition. In this sense, the rule which is considered sporting might not have the effect on economic freedoms of athletes or clubs guaranteed to them under Articles 39, 43, and 49, but it might have such effect on the guarantees under Articles 81 and 82; purely internal situations are outside the scope of internal market rules but may not be outside competition rules; internal market rules are addressed to states and competition rules to undertakings (on the other hand, rules of private bodies, such as sporting federations, have been found in breach of provisions freedom of movement provisions,[47] and conversely, public bodies have been a subject of the competition provisions.[48]). The consensus seems to be that while there is a need for *functional* convergence and methodological comparability, there is no and cannot be a *total* convergence (i.e. at the level of detail) in the enforcement of the two sets of provisions. [49]

Selected issue #2: Sports broadcasting[50]

Structure of the sports broadcasting market

The market for sports broadcasting used to be, and to some extent still is, organised in a monopoly/monopsony structure, i.e. it is characterised by the presence of a dominant seller and a dominant buyer. As pointed out in the introductory paragraphs of this paper, the buying side has witnessed decartelisation but the selling side has stayed highly centralised which has had implications for the ability of sporting federations to affect the competition between broadcasters in the downstream market.

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[47] For sports related cases see for example, C-415/93 *Bosman* [1995] ECR I-4921, or Case 13/76 *Gaetano Donà v. Mario Mantero* [1976] ECR 1333.

[48] See, for instance, Case 155/73, Italy v Sacchi [1974] ECR 409 for public television broadcasting organization, C-244/94, *Fédération Française des Sociétés d'Assurance and others v. Ministère de l'Agriculture et de la Pêche* [1995] ECR I-4013 for voluntary old-age pension scheme for agricultural workers or C-35/96 *Italy v. Commission* [1998] ECR I-3851 for independent customs agents, *EBU* [1993] OJ L179/23 for European Broadcasting Union.

[49] Kamiel Mortelmans 'Towards Convergence in the Application of the Rules on Free Movement and on Competition', 38 CMLR (2001) 613; Stephen Weatherill, 'Fair Play Please!: Recent Developments in the Application of EC Law to Sport', 40 CMLR (2003) 51, pp 80-86; R. O'Loughlin, 'EC Competition Rules and the Free Movement Rules: An Examination of the Parallels and their Furtherance by the ECJ *Wouters* Decision' [2003] ECLR 62.

[50] Due to the page limit and the complexity of this subject, it will be treated here only in an outline. It is important as a background to the topic treated under Selected issue #3 *infra*.

Competition concerns with regard to collective sales and exclusivity clauses

In most European sports, the condition for participation in a league is the transfer of the commercial rights to a governing body by the clubs. Governing bodies then create a single point of sale and bundle the rights for offer to broadcasters often on an exclusive basis. Such collective selling amounts to horizontal price fixing, the hard core cartel specifically referred to in Article 81(1) (a). The justification cited in support of this arrangement is the need to maintain competitive balance between league participants which is achieved by the subsequent distribution of profits acquired by means of joint selling. In addition, the exclusivity clause in the broadcasting contracts tends to separate Member States' territories along national lines, but it is the norm in the industry reflecting the predominantly national focus of the sports market. Also, it protects the value of the rights for both buyers and sellers and encourages investments in innovative programming. Exclusivity is not prohibited *per se* and will be examined in the light of the duration of commitments in relation to the time needed for the broadcasters to recoup their investments as well as in the light of the foreclosure effect on potential new market entrants. Availability and conditions of licensing will play a role in assessing the nature of exclusivity. Apart from this restriction on competition in the downstream market, two other effects of broadcasting agreements are of particular concern to the competition enforcers: the impact it has on consumers in terms of choice and price and the restrictions on commercial undertakings (clubs) to exploit their rights on an individual basis.[51]

UEFA Champions League,[52] Budesliga[53], and the FAPL[54] cases

The Commission was dealing with the issue of collective sales of Champions League rights on an exclusive basis by the UEFA[55], German *Bundesliga* rights by the German Football League, and Premier League rights by the FAPL. In all cases, the collectivity was not condemned as such, but the unbundling of rights to make them accessible to the wider range of operators (in other words, to make

[51] For the more detailed treatment of the later, see the paragraphs *infra* on breakaway structures in sports.

[52] Decision 2003/78 *OJ* 2003 L291/25.

[53] Decision 2005/396 *OJ* 2005 L134/46.

[54] Decision C (2006) 868. See also IP/06/356, 22 March 2006 available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/06/356&guiLanguage=en

[55] Champions League is one of the most watched events on television. An estimated EUR530 million of its revenues in 2000/2001 season came from television rights, which were sold by UEFA to a single broadcaster in each EU Member State for three- to four-year periods.

the conferred exclusivity less exclusive) was a condition for the exemption. In 2002 UEFA proposed a revised, unbundled selling policy based on segmentation of exploitation of rights to TV, radio, internet, Universal Mobile Telecommunications System, and physical media such as DVD, VHS, and CD-ROM. *Bundesliga* has entered into similar unbundling commitments and has limited the period of the duration of the contracts with operators to three years maximum. Similarly, in the Football Association Premier League, the commitments were shortened from five to three years and the league has entered into a series of other undertakings including an increase in the number of matches available for live TV transmission and the sale of rights in packages with no buyer being able to acquire all of them. This resulted in BSkyB, a broadcaster which used to hold all the exclusive rights, acquiring four out of the six packages available.

Selected issue #3: Breakaway structures in sports

Relevant rules of the sporting bodies and breakaway threats, so far

A distinct but related issue which has attracted a lot of attention (and might do so even more in the years to come) is about distribution of profits generated from the collective sales of commercial rights, in particular in the UEFA Champions League and Formula One motor races. Namely, commercially most powerful football clubs[56] and F1 teams[57] were becoming less and less happy about vertical and horizontal financial solidarity mechanisms underlying distribution of revenues among the participants in the league. They considered that sales on individual basis and freedom to dispose of the accrued profits as they desired presented a more lucrative opportunity[58] and called for the establishment of an alternative structure which would, in all likelihood, have brought about commercial death for the Champions League and F1 series.

With a different agenda in mind, UEFA, FIA[59], and other sport federations fiercely oppose any such breakaway endeavours. Their rules are designed to impose severe financial and sporting penalties on teams participating in any alternative competitions without their prior approval, which is highly unlikely to be given to

[56] Known as G14 group which is in fact a group consisting of 18 different European football clubs including Manchester United, Real Madrid, Bayern Munich, Milan, Arsenal and others.

[57] F1 team consists of two drivers and a constructor supported by sponsors.

[58] The system of individual sales by the clubs exists in some countries, such as Italy and Sweden.

[59] Fédération Internationale de l'Automobile, governing body for worldwide automobile sports including F1.

any permanent establishment due to its terminal effect on the crown jewels of their respective dominions.

Articles 49(1) and (3) of the UEFA Statutes provide that:

> 'UEFA shall have the sole jurisdiction to organize or abolish international competitions in Europe in which Member Associations and/or their clubs participate. […] International competitions and international tournaments which are not organized by the UEFA shall require approval of the later.'

The situation is different in F1 motor races in the sense that the terms of the Concorde Agreement negotiated between F1 teams, FIA, and F1 Administration are secret as it is considered to be a contract governing relationships between private parties. However, the 1997 version of it leaked to the net three years ago. [60] Even before that we did have some knowledge of the agreement from the 1999 Commission investigation into the abuse of dominant position by FIA and its administrative and marketing companies.[61] The specific points under investigation were *inter alia* the fact that the terms of the Concorde Agreement prevented F1 teams from racing in any other series, and that drivers, track owners, vehicle manufacturers, organisers of motor sport events would have to obtain prior authorisation to stage a motor sport event. One author has described this situation as FIA's controlling all the factors of production needed to produce motor sport (Cygan 2007, 74 et seq.). In addition, FIA had claimed commercial rights in all the motor sport events it authorised. Following the Statement of Objection by the Commission, FIA has entered into a series of commitments separating to some degree its commercial and regulatory functions and closing the investigation in 2001. The subsequent Concorde agreement, as last amended in 2008, presumably contains different rules. Recent media reports appear to indicate that there was a lot of tension between the leading manufacturers and the FIA, but that the compromise has been reached, and the leading F1 teams have already signed the agreement.

With respect to football, the threat has also been curtailed for the time being. When in 1998 Media Partners International Ltd. offered £1.2 billion to 18 clubs to

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[60] The 1997 version of the agreement has leaked to the net and is available at http://www.concordeagreement.com

[61] F1 Administration which sells the television rights to F1 Championship and International Sportsworld Communicator which marketed the broadcasting rights, respectively. Notice published pursuant to Article 19(3) of Council Regulation No 17 concerning Cases COMP/35.163 – Notification of FIA Regulations, COMP/36.638 . Notification by FIA/FOA of agreements relating to the FIA Formula One World Championship, COMP/36.776 – GTR/FIA & others (2001/C 169/03).

form a new European Super League, UEFA reacted by establishing an expanded Champions League and merging the European Cup-Winners' Cup with the UEFA Cup.[62] The participation in the Champions League was (and still is) conditioned upon the transfer of broadcasting rights to UEFA. The proceeds from collective sales, however, ceased to satisfy the clubs who wanted a bigger piece of cake. They threatened with a breakaway. Under the mounting tensions in January 2008, the FIFA and G14 entered into a peace deal resulting in the creation of a pool compensating for player release discussed in detail below.[63] In return, G14 had to formally disband, but its executive insisted that their goals had been met by these financial concessions.

Most recently and closer home, talk of the creation of a breakaway Nordic league in hockey has made headlines in many Scandinavian news channels, bringing up all the familiar questions in familiar circumstances. For the purposes of our topic, the big question is whether the rules of sporting federations which prevent, restrict, or condition the creation of breakaway structures violate Articles 81 and/or 82? Should the clubs be allowed to 'take the ball and go home', and under which conditions, if any?

Which test?

The most important initial aspect for arriving at the correct answer to these questions is which test to apply to determine the compatibility of the rules with competition articles. The ECJ case law does not shed much light as there are no direct precedents in the sports sector. The closest analogy on breakaway structures is supplied by the *Danish Cooperatives (Gøttrup-Klim)* case decided in 1994 in the context of agriculture.[64] Therein, an agricultural cooperative was permitted to place a restriction on their members to participate in alternative agricultural cooperatives on the basis that the restriction in fact benefited competition and was necessary to protect legitimate goals necessary for the functioning of the cooperative. In the Court's own words, exempting the restrictive rule from the ambit of the competition articles:

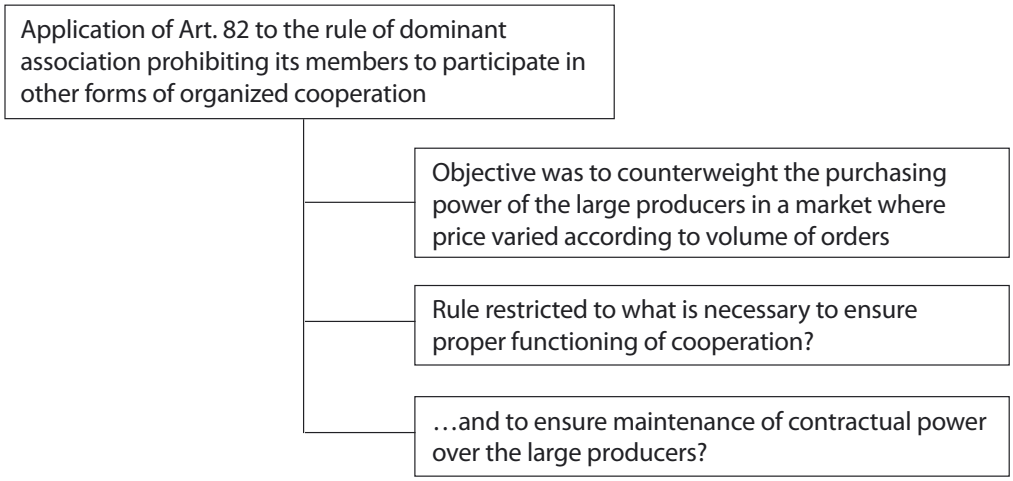
> *'A provision in the statutes of a cooperative purchasing association, forbidding its members to participate in other forms of organized*

[62] See articles available on http://sportsillustrated.cnn.com/soccer/world/news/1998/08/28/uefa_superleague/ and http://findarticles.com/p/articles/mi_qn4158/is_19981007/ai_n14195691.

[63] See the paragraphs under Selected issue #4 *infra*.

[64] Case C-250/92 *Gøttrup-Klim e.a. Grovvareforeninger v Dansk Landbrugs Grovvareselskab AmbA* [1994] ECR I-5641.

cooperation which are in direct competition with it, is not caught by the prohibition in Article 85(1) [now Article 81(1)] of the Treaty, so long as the abovementioned provision is restricted to what is necessary to ensure that the cooperative functions properly and maintains its contractual power in relation to producers […]Even if a cooperative purchasing association holds a dominant position on a given market, an amendment of its statutes prohibiting its members from participating in other forms of organized cooperation which are in direct competition with it does not constitute an abuse of a dominant position contrary to Article 86 [now Article 82] of the Treaty, so long as the abovementioned provision is limited to what is necessary to ensure that the cooperative functions properly and maintains its contractual power in relation to producers."[65]



Fact-specific flowchart under C-250/92 Danish Cooperatives case

This case is often cited in support of maintenance of the rules placing restrictions on breakaway structures, but drawing any such analogy would require more thorough consideration than undertaken so far, with all due respect. More importantly, we now have guidance in *Meca-Medina* on the application of competition law to sports even though the case was not related to the specific problem of breakaway structures.[66] Before getting caught in the debate as to which of the two cases

[65] *Ibid*. para. 45 and 52, respectively. Italic emphasis by the author.

[66] Also European Commission White Paper on Sports 2007, para. 2.1.2 sets an approach to organizational rules of the sports bodies along the same lines.

provides the more appropriate framework for legal analysis, we should stop and recognise that the test in both cases is essentially the same. This means that at the end of the day it will make no difference for the outcome of the analysis or for the process by which we arrive to our conclusions, whether we put the facts through the analytical framework of *Meca-Medina* or that of *Danish Cooperatives*.

Application of the test

We have now arrived at a more practical segment of the issue: the application of the test to the facts of the case. As we have seen there are three parts to it:

1. the overall context in which the rule was adopted or produces its effects and its objectives;
2. whether the restrictions caused by the rule are inherent and/or necessary in the pursuit of those objectives; and
3. whether the rule is proportionate in light of the objective(s) pursued.

The contextual approach to the adoption of the rule and to its effects makes it possible to assess the objective of the rule in its proper function and setting, from its birth until it begins and continues to produce economic consequences downstream in the pyramid. FIA and UEFA would put forward different justifications for their restrictive rules. Whereas FIA could claim that the only reason the formation of breakaway structure is restricted is to ensure a proper standard of safety of events and orderly conduct of the motor sports, UEFA would rely on solidarity and the social function of football, preservation of competitive balance, and effective organisation of sport. Reasons put forth to justify the rules of UEFA have already been accepted as legitimate.[67] For the sake of opening up to another perspective, it is interesting to consider that football performs important social function, while motor races, F1 in particular, do not. The access to motor sport, even on all levels, requires substantial finances and, unlike football, it is not a 'sport for all': it is first business and then a sporting activity (Cygan 2007, 74 et seq.). This social function of the UEFA rule is important because in the conflict between the Community's social objectives and economic objectives, it is usually social objectives that would

[67] White Paper on Sport summarised the approach as follows: '**Legitimate objectives** of sporting rules will normally relate to the "organisation and proper conduct of competitive sport" and may include, e.g., the ensuring of fair sport competitions with equal chances for all athletes, the ensuring of uncertainty of results, the protection of the athletes' health, the protection of the safety of spectators, the encouragement of training of young athletes, the ensuring of financial stability of sport clubs/teams or the ensuring of a uniform and consistent exercise of a given sport (the "rules of the game"). The specificity of sport, i.e. the distinctive features setting sport apart from other economic activities, such as the interdependence between competing adversaries, will be taken into consideration when assessing the existence of a legitimate objective.'

prevail as long as they are proportionate.[68] Consider also the hypothesis (which is also advanced below) in relation to the collective dominance of the (former) G14 clubs and resulting 'special responsibilities' of dominant undertakings which should perhaps be aligned with corporate social responsibility in its modern meaning, and the case for UEFA rule looks even better.

When it comes to the two remaining parts of the test we have embarked on an intellectual exercise involving a perplexity of issues which also involves also going back to the first part of the test. In conceptual terms it is easy to distinguish between different parts of the tests but considering that:

> 'Although inherent rules do not constitute restrictions within the meaning of free movement law, the process of analysis involves an examination of proportionality of the rule and the relationship between fundamental rights and the rule purported to be inherent. As a consequence, the distinction between objective justification and the process of determining whether a rule is inherent is limited to the Court's treatment of proportionality of inherent rules: the Court appears less inclined to examine the proportionality of inherent rules and more inclined to require that applicants demonstrate its disproportionality, whereas in the context of objective justification the party purporting to objectively justify the rule is required to demonstrate that no less restrictive means will achieve the same, justified ends.' (Parrish and Miettinen 2008, 101).

This excerpt, which blurs the conceptually dividing line between different parts of the test, relates to the free movement law, and it brings us back to the undecided relationship between the internal market and competition law. If we take the functional convergence and methodological comparability theory as a guideline, it would appear that there is no reason to treat dissimilarly the analytical approach undertaken under the two sets of provisions. The issues addressed by the authors may well be applicable in the competition context. That would carry implication for the burden of proof under Article 81. Namely, all parts of the test are carried out under Article 81(1) under which burden of proof was traditionally for the applicant to bear, whereas in relation to the free movement provisions the burden is on the party relying on the rule. The simplest solution would be to adopt the same approach in the analytical framework of Article 81(1) when applied to sports cases.

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[68] Case C-341/05 *Laval un Partneri Ltd v. Svenska Byggnadsarbetareförbundet, Svenska Byggnads arbetareförbundets avd. 1, Byggettan, Svenska Elektrikerförbundet*, [2007] ECR I-0000, judgment of 18 December 2007 and Case C-438/05 *The International Transport Workers' Federation and The Finnish Seamen's Union v. Viking Line ABP, OÜ Viking Line Eesti,* [2007] ECR I-0000, judgment of 11 December 2007.

Proportionality is without doubt at issue in the rules involving restrictions on breakaway structures. The question is: are there any other less restrictive means to achieve the same goals? My argument would be that if there is a way to ensure that the new structure would preserve and protect the objectives as efficiently, there is no reason not to allow the clubs to break away other than nostalgia towards the European model of sports. So if there were a way for FIA to ensure that the new structure would be complying with highest safety standards and provide for proper self-governing administration, what argument against breakaway could FIA put forth? Another question is whether the rules are even suitable for (i.e., capable of) achieving the goal. They are probably not. For now it has worked but only because a lot of compromises were made to accommodate the teams and fend off the breakaway threats for the time being. So it is the compromises and the influence that the commercially most powerful clubs and teams have on their respective governing bodies and not the restrictive rules that have kept the structure intact.

Breakaway structures: a threat to the European sports model?

The desire to preserve the European model of sports has been specifically mentioned in several policy statements:

> There is a European model of sport with its own characteristics. This model has been exported to almost all other continents and countries, with the exception of North America. Sport in Europe has a unique structure. For the future development of sport in Europe these special features should be taken into account.[69]

The question as to the degree in which the structure would be a threat to the European sports model remains dependant on development of many other dynamics. Factors such as whether the closed private leagues would become a widespread phenomenon, whether the clubs participating in alternative championships would retain ties with their national federations and to what extent, would the players be eligible to play in national teams, what level of dependence with the central bodies would they have, etc. would play a big part. Doubtless, even a single breakaway would constitute an erosion of the structure. If we assume that the European Super League in football that operates completely independently and separately from the rest of its discipline is established by former G14 members, the European structure as such could in principle continue in the same old way albeit resized, short of its golden goose, and facing a multi-level competition from its former members.

[69] European Model of Sports, Consultation Document of DG X, European Commission, para. 1.3.

The most important unintended consequence…

…of the creation of alternative championships would be the effect on the third party commercial rights under contracts with the sports federations, in particular broadcasters' contracts to transmit league matches. Taking into consideration that, with the best clubs leaving, the league would be substantially changed, a number of legal questions would have to be resolved: is the transmission of the matches between clubs remaining within the structure the only right left for the broadcasting; do the broadcasters have a right to damages for breach of contract by the league or to the damages in tort by the clubs; do they have the right to broadcast the matches of the new structure for the duration of the contract; what about final consumers (viewers) whose contracts with broadcasting companies would also be affected? These questions should be resolved in accordance with the applicable national laws. Anyway, the problem would not occur if a potential formation of the closed private leagues would take place on the expiry of broadcasting contracts, and that is something that should be borne in mind by the (collectively dominant) clubs to avoid unfair consequences to the third party rights and the rights of the ultimate consumers.

Selected issue #4: Compulsory release of players for international matches

Content of the rule and comment

Article 1 of the Annex 1 of the FIFA Regulation on Status and Transfer of Players lays down an obligation on clubs to

> 'release their registered players to the representative teams of the country for which the player is eligible to play on the basis of his nationality if they are called up by the association concerned. Any agreement between a player and a club to the contrary is prohibited.'[70]

There are not many serious objections that can be raised against this rule as it stands unqualified. It is an honour and right for any athlete to represent his or her country if called upon by national associations but also an opportunity for national associations to field their finest talent against that of other countries. International competitions hold special appeal to the audience and promote the sense of national identity which is *inter alia* a cultural aspect and value of the sport Europe is aspiring to protect. Continental championships, World Cup, as well as qualifying

[70] Article 1 of the Annex 1. FIFA Regulation on Status and Transfer on Players can be found on: http://www.fifa.com/mm/document/affederation/administration/regulations_on_the_status_and_transfer_of_players_en_33410.pdf

matches for international tournaments are examples belonging to the category of competitions for which compulsory release is required.

However, matters become more complicated when reading the rule in its proper context, i.e. in conjunction with Article 2 of Annex 1 which emphasises the responsibility for financial and insurance matters:

> 'Clubs releasing a player in accordance with the provisions of this annexe are not entitled to financial compensation.[…] The club with which the player concerned is registered shall be responsible for his insurance cover against illness and accident during the entire period of his release. This cover must also extend to any injuries sustained by the player during the international match(es) for which he was released.

Furthermore, disciplinary sanctions for failure to comply with Article 1 are laid down in Article 6 of Annex 1:

> 'If a club refuses to release a player or neglects to do so despite the provisions of this annexe, the FIFA Players' Status Committee shall furthermore request the association to which the club belongs to declare any match(es) in which the player took part to have been lost by the club concerned. Any points thus gained by the club in question shall be forfeited. Any match contested according to the cup system shall be regarded as having been won by the opposing team, irrespective of the score.'

These rules on compulsory and uncompensated release of players for international matches of their national representative teams have attracted a lot of criticism. Pressure upon FIFA to change the rules has been exerted in particular by G14. Apart from giving up the player for the duration of the competition for which he was released, the main problem is that players can get injured or come back tired, and there is no possibility for the clubs to obtain financial compensation *vis-à-vis* the damages sustained.

While it is true that the richest clubs are the ones that have in their squads, more so than the others, a lot of high-quality foreign players[71] and that the release for international matches will therefore affect their composition more profoundly, we must stop to remind ourselves of the specificities of the sport industry and the need to maintain the competitive balance. In this context, I would argue that although affecting commercial interests of the clubs, the rule represents one of the mechanisms for maintenance of competitive balance between league participants. It might counterweight the fact

[71] Some clubs, such as Arsenal and Chelsea, famously fielded the all-foreign start-up line following the ECJ ruling in *Bosman.*

that Real Madrid has better purchasing power and can afford the contracts with the best players more than many other less well off clubs. Risk is upon everyone, the richest clubs more than others due to their composition, and the clubs must take this into account when buying players. It should be taken as an intrinsic characteristic of the industry and of their business when operating on the supply market. These arguments would provide a firm support to the rule in the application of the analytical framework provided for in the *Meca-Medina* judgment.

Separate comments can be made concerning the efforts to fight excessive commercialisation in sports. How rich do the clubs really need to be and at the cost of which values? Being probably collectively dominant, the G14 group, and its counterparts in other disciplines, has (did have) certain responsibilities attached to its status, and a degree of solidarity should be a part of the corporate or dominant undertakings' responsibility in the European sports industry.[72]

Oulmers/Charleroi case and the 2008 FIFA-G14 deal

In the relatively recent *Oulmers* case[73], the Belgian club Charleroi challenged the Annex 1 rules before the Belgian national court when their player of Moroccan nationality returned injured after being released to play for his national team. G14 has joined the action stating that

> "G14's objective in bringing this case is to avoid professional clubs being forced to incur damages when they release their players for national team duty. G14 want a situation in which a fair percentage of the revenues of tournaments, notably the World Cup, are redistributed among those clubs who release their players."[74]

Question forwarded on preliminary reference procedure by the Belgian national court in Charleroi asked the ECJ to consider

> 'Do the obligations on clubs and football players having employment contracts with those clubs imposed by the provisions of FIFA's statutes and regulations providing for the obligatory release of players to national federations without compensation and the unilateral and binding determination of the coordinated international match calendar

[72] The argument presented is related but logically distinct from the issues involving lack of transparency and democratic representation in the making of the rules by the governing bodies which is something the clubs relied on to support their case in *Oulmers*. See the paragraphs below.

[73] Case C-243/06 *SA Sporting du Pays de Charleroi, G-14 Groupment des clubs de football européens v Fédération internationale de football association (FIFA)*. The case was settled out-of-court and will be deleted from the Courts register.

[74] Article is available on http://www.independent.co.uk/sport/football/news-and-comment/g14-clubs-demand-share-of-world-cup-gate-.htmlipts-471026.html.

> constitute unlawful restrictions of competition or abuses of a dominant position or obstacles to the exercise of the fundamental freedoms conferred by the EC Treaty and are they therefore contrary to Articles 81 and 82 of the Treaty[…]'?[75]

Unfortunately for those that looked forward to the clarification by the Court, the *Oulmers* case was settled shortly before the judgment was due, and legal action was dropped as a part of the broader deal struck between G14 and FIFA in January 2008.[76] The deal involved G14 disbandment and dropping the pending cases against FIFA, and, in return for the removal of breakaway threat, FIFA/UEFA created a compensation pool for every player released under Article 1 of Annex 1. Sport Business International reported that

> 'the money will be drawn from a central pool financed by UEFA and FIFA from the commercial money raised from the sale of TV rights and tournament sponsorships. Although the exact amounts remain undecided, it is understood that each club will receive the same amount for every player they provide – irrespective of the players' club salaries'.[77]

The only reason FIFA shook hands on the deal seems to be the fear of formation of an alternative league by G14. It is regrettable, though, that it finally yielded to pressures, for there would be not much support for the legal action taken against its rule, especially since it concerns the sports sector with all its specificities and corresponding soft application of law.[78] Notwithstanding its formal disbandment, G14 will continue to present a powerful lobby group with special commercial interests not possessed by all other competitors in their league. Upon the conclusion of the January 2008 deal, their role has not ended *de facto*; it has just been deinstitutionalised and re-institutionalised.[79] Informal negotiations on the issues which affect their common interests will most likely go ahead every time when there is a need for it.

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[75] Reference for a preliminary ruling from the Tribunal de commerce de Charleroi lodged on 30 May 2006 – Case C-243/06 *SA Sporting du Pays de Charleroi, G-14 Groupment des clubs de football européens v Fédération internationale de football association (FIFA)*. Factually similar case involved French club Olympique Lyon and a player Eric Abidal who broke metatarsal bone during friendly with Costa Rica.

[76] See for example press release in Guardian available at http://www.guardian.co.uk/football/2008/jan/16/newsstory.sport7.

[77] Available at http://www.sportbusiness.com/news/163326/g14-group-to-disband-after-fifa-uefa-agree-compensation-deal.

[78] For the alternative argument see Stephen Weatherill, 'Is the Pyramid Compatible with EC Law?' 3-4, International Sports Law Journal (2005) p.6.

[79] Clubs are now represented in a wider European Clubs' Association (ECA) which has 103 members from 53 associations. This organization has also replaced the European Club Forum. It is chaired by Karl-Heinz Rummenigge of FC Bayern München.

PART III: THE FUTURE OF THE LEGAL REGULATION

In conclusion to this paper it is important to touch upon some of the prospects which are on the horizon of the European legal regulation. First and foremost, Article 149 as amended by the Lisbon Treaty has given the first express Treaty a base for the Community legislative competence in the sports sector.[80] Inclusion of the Treaty article for sports can mean a lot of things, and when and if the treaty is ratified will depend on the way it is applied and interpreted. Some things are clear though: the legislative action on the Community level is only meant to supplement that of the Member States and not to supersede their competence on the matter. The socio-cultural coalition would see it as a victory, but it might be too early for any such declaration due to the seemingly limited application of the article in the field of professional sport or the fact that ECJ case law and other Treaty articles will remain of equal importance for the sector as thus far.

Furthermore, Articles 138-9 of the EC Treaty make the Commission responsible for promoting and supporting the European social dialogue. Studies are under way to identify the labour-related themes and issues suitable to be dealt with by means of social dialogue in professional football[81] but as of recently also in other professional sports (such as basketball and cycling). Social dialogue should result in collective agreements entered into by both sides of the industry representatives and would play a significant role in shaping employment relations and working conditions. In terms of application of competition law, such collective agreements would fall out of the ambit of competition articles altogether on the basis of the well-established

[80] What follows is the relevant text in the consolidated version of the Treaty on Functioning of the European Union: Article 2(5) 'In certain areas and under the conditions laid down in the Treaties, the Union shall have competence to carry out actions to support, coordinate or supplement the actions of the Member States, without thereby superseding their competence in these areas.' Article 6 further provides that '[…] The areas of such action shall, at European level, be: […] (e) education, vocational training, youth and sport; […]'Article 165(1) second indent: 'The Union shall contribute to the promotion of European sporting issues, while taking account of the specific nature of sport, its structures based on voluntary activity and its social and educational function. (2) Union action shall be aimed at: […] developing the European dimension in sport, by promoting fairness and openness in sporting competitions and cooperation between bodies responsible for sports, and by protecting the physical and moral integrity of sportsmen and sportswomen, especially the youngest sportsmen and sportswomen. (3) The Union and the Member States shall foster cooperation with third countries and the competent international organisations in the field of education and sport, in particular the Council of Europe. Paragraph 4 of this article gives the legislative basis for adoption of relevant legislation.

[81] See press release in International Sports Law Review, 1-2, p 109 (2008). Two sides of the industry in football are International Federation of Professional Footballers' Associations-Division Europe (FIFPro) on the side of employees and the Association of European Professional Football Leagues (EPFL) complemented by the European Club Association (ECA) on the side on employers.

exemption in the *Albany, Brentjens* and *Drijvende Bokken* line of case law.[82]

Finally, adoption of block exemption regulation for sports would reduce the number of cases filed and enhance legal certainty for the whole of the industry, but it is likely to become of more importance only later in the not-so-near future when sufficient experience in enforcement of competition law in the sports sector is acquired. Soft law and policy statements resulting from political dialogue can be expected to continue to play a significant role in development of policy agenda.

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[82] **Case C-67/96** *Albany International BV v. Stichting Bedrijfspensioenfonds Textielindustrie* [1999] ECR I-5751, cases C-115, 116 & 117/97 *Brentjens' Handelsonderneming BV v Stichting Bedrijfspensioenfonds voor de Handel in Bouwmaterialen* **[1999] ECR I-6025 and** case C-219/97 *Drijvende Bokken* [1999] ECR I-6121.

The taxation of outbound dividends in Estonia as infulenced by European Court of Justice case law

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The taxation of non-residents is becoming an increasingly important topic both in Estonia and in the EU, due to the incremental number of judgments of the European Court of Justice (ECJ) in the mentioned field. Tax provisions of the EC Treaty[1] regulate in the first place indirect taxes, because historically indirect taxes have been more important in the EU since they have been serious obstacles to the free movement of goods. Thus, the EC Treaty does not include provisions *expressis verbis* regulating direct taxes, and the latter are regulated mostly by stipulations connected with fundamental freedoms. Even though there are a few Council Directives in the field of income tax, the importance of the ECJ is increasing substantially in respect to direct taxes. At the end of 2008, it could be concluded that half of the ECJ decisions since 1960 in the field of direct taxes have been made during the last 5 years.

Estonia, as one of the member states of the EU, has to observe ECJ decisions in order to ensure that its legislation is in compliance with the EC Treaty and the secondary legislation of the EU. The purpose of this article is to analyze the influence of ECJ case law to Estonian income tax legislation and whether Estonian legislation is in compliance with the EU legislation and international principles in respect to the taxation of non-residents. In order to limit the scope of this article, the author has analyzed the withholding taxes related to dividends. The article is based on the master thesis of the author submitted to International University Audentes (Estonia) in April 2007.

Estonian domestic legislation before 2009

According to the Estonian Income Tax Act[2] Article 29 Section 8 and Article 41 Subsection 5, dividends paid to non-residents were subject to withholding income tax until the end of 2008 if the recipient is a legal person holding less than 15% of the

[1] Treaty Establishing the European Community. 25 March 1957. – OJ C 325, 24.12.2002.

[2] Tulumaksuseadus [Income Tax Act], 15 December 1999, State Gazette I 1999, 101, 903; 2008, 48, 269.

shares of the dividend distributor. If this was the case, an income tax withholding of 21% upon the gross amount was applied. Still, Estonia has concluded over 40 double taxation avoidance treaties, which as a rule decreased the income tax withholding rate to 15%. Historically, this provision has been effective for years, but the tax rate has decreased from 26% to 21%, according to the general reduction of the income tax rate in Estonia. In addition, the participation threshold has been reduced according to the Parent-Subsidiary Directive[3] from 25% to 15% in 2008 over the years.

On the other hand, there was and is no income tax withholding upon dividend payments to resident legal persons irrespective of the size of holding. Before the year 2009, all the dividends paid to a legal person registered in a low tax rate territory were subject to income tax withholding at a rate of 21% irrespective of the size of holding. Nevertheless, all the EU or the EEA states were and are excluded from the definition of low tax rate territories.

Historically, Estonia has applied income tax withholding upon dividends paid to non-resident minority shareholders who were natural persons. Since May 1, 2004, when Estonia accessed the EU, such withholding tax was abolished in the case of dividend payments to non-resident natural persons[4]. Thus, since 2004, no income tax withholding is applied in the case of dividend payments to natural persons irrespective of their tax residence. Therefore, it may be assumed that there is no discrimination of non-resident natural persons in relation to outbound dividends paid by Estonian companies.

According to the Estonian legislation applicable before 2009, dividends paid to non-resident minority shareholder legal persons were subject to income tax withholding, whereas all dividends paid to resident taxpayers were not subject to income tax withholding. Such variance refers to a possible discrimination of non-residents and hindrance of free movement of capital in the EU (EC Treaty Article 56) and freedom of establishment in the EU (EC Treaty Article 43).

Still, it should be considered that according to the Estonian Income Tax Act, double taxation arises also in the case of minority shareholders, which are Estonian tax resident legal persons. Namely, participation exemption was applied in relation

[3] Council directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (90/435/EEC). 23 July 1990. – OJ L 225, 22.9.1990, p. 6.

[4] Tulumaksuseaduse, kohalike maksude seaduse ja maksukorralduse seaduse muutmise seadus [Act to Amend Income Tax Act, Local Taxes Act and Taxation Act], 20 May 2004, State Gazette 2004, 45, 319.

to further dividend payments only if a resident company owns at least 15% of the shares or voting rights in another company, which has paid dividends to the first one. According to Article 50 Section 1[1] Subsections 1 and 3 of the Income Tax Act applicable until 31 December 2008, dividends paid by an Estonian resident company are tax-exempt if one of the following conditions is met:

1) the resident company paying the dividend has derived the dividend, which is the basis for the payment from a resident company of a Contracting State[5] or the Swiss Confederation taxable with income tax (except for companies located within a low tax rate territory) and at least 15 % of such company's shares or votes belonged to the company at the time of deriving the dividend;

2) the company paying the dividend has derived the dividend, which is the basis for payment from a company of a foreign state not specified in clause (1) (except for a company located within a low tax rate territory) and at the time of deriving the dividend, the company owned at least 15 % of the shares or votes of such company, and income tax has been withheld from the dividend or income tax has been charged on the share of profit on which is the basis thereof.

According to these cited provisions, if an Estonian resident company had been received dividends from another company for a shareholding of less than 15%, distribution of profit including the dividends received for such a holding was subject to corporate income tax at the rate of 21/79 of the net amount. Thus, dividends received for a minority shareholding by a resident legal entity were and are subject to (corporate) income tax at the moment when these dividends are further distributed to the shareholders of the recipient. Therefore, it may be concluded that the difference related to taxation of dividends received by resident and non-resident legal persons, who were and are minority shareholders, is mainly a timing difference. In the case of non-residents, taxation was applied immediately by way of withholding, but in the case of resident shareholders, corporate income tax was applied on further dividend distribution. Still, there could be situations, which did not trigger further taxation in the case of a resident legal person who had received dividends in relation to a shareholding of less than 15%. For example, if the recipient of dividends had a loss and therefore was not able to distribute profits, additional income tax was not paid at the level of the recipient – resident minority shareholder legal entity. Another similar situation was if the recipient of dividends was liquidated or profit is distributed in the form of payment of capital reduction or share buy-back before 2009[6]. It may

[5] Defined in the Income Tax Act as a contracting state of the European Economic Area (i.e. EEA).

[6] Until 31.12.2008 liquidation proceeds, payments in the case of capital reduction or share buy-back are taxable at the level of recipient as capital gain.

be concluded that the difference of taxation of resident and non-resident minority shareholders was not merely in timing, but there could be situations in which the dividend income of the resident minority shareholder was never taxed differently from a non-resident minority shareholder, whose dividend income was subject to an immediate withholding of income tax.

In addition to the timing difference, dividends paid to non-resident minority shareholder legal entities have been in fact subject to higher income tax withholding rates compared with resident persons. The Estonian income tax rate has been decreased from 26% to 21% since 2005. In the case of minority shareholders for example, a non-resident legal entity A and a resident legal entity B have received dividends from an Estonian company C, dividends paid to the non-resident legal entity A have been subject to income tax withholding, according to the tax rate applicable during the year of the dividend payment. The dividends received by the resident legal entity B were subject to income tax at the moment of profit distribution by legal entity B, which usually occured at least not before the next financial year. Taking into account the gradual decrease of the tax rate in Estonia from 26% to 21%, it was very likely that the income tax rate applied to profit distribution of the dividends received by a resident legal entity B was lower than the withholding income tax rate applied to dividends paid to non-resident A. Therefore, it could be concluded that in addition to the timing difference there was also likely a higher tax rate applicable in respect to dividends paid to a non-resident legal entity.

Infringement procedure against Estonia

In January 2008, the European Commission sent a request for information in the form of a letter of formal notice (the first step of the infringement procedure of Article 226 of the EC Treaty) to Estonia about the rules under which dividends paid to foreign pension funds may be taxed more heavily than dividends paid to domestic pension funds[7]. According to the letter, in Estonia dividends paid by Estonian companies to Estonian pension funds are not subject to tax, whereas dividends paid to non-resident pension funds are subject to a withholding tax of 22%. According to the opinion of the Commission, if a Member State levies a higher tax on dividends (or interest) paid to foreign pension funds, this may dissuade these funds from investing in its companies. Equally, companies established in that Member State might face increased difficulties in attracting capital from foreign pension funds. The higher taxation of foreign pension

[7] European Commission. (31.01.2008). IP/08/143. Taxation of outbound dividends: Commission takes steps against Germany, Estonia and the Czech Republic. Available: http://europe.eu/rapid/

funds may thus result in a restriction of the free movement of capital as protected by Article 56 EC and Article 40 EEA. The proceeding against Estonia was closed on 18.09.2008 on Estonia's promise to repeal the withholding tax by 2010.

Even if it could be mostly an issue of cash flows, the opinion of the Commission has been that Estonia must abolish income tax withholding on payments to non-resident pension funds.[8] According to the interpretation of the Estonian Tax Authorities, the tax residence of funds without legal entity status was determined on the basis of the tax residency of the fund manager. Therefore, dividends paid to a pension fund managed by a non-resident were subject to income tax withholding, whereas dividends to a pension fund managed by a resident were not. Although the infringement procedure was initiated in relation to outbound dividends paid only to pension funds, the actual problem could be concerning all outbound dividend payments to minority shareholders, which were legal entities resident elsewhere in the EU or EEA.

Approach of the Commission

The taxation of outbound dividends has been an important issue to the Commission for years. In addition to several recent infringement proceedings[9] and disputes in the ECJ, the European Commission has issued several communications on taxation that concern also taxation of dividends not regulated within the Parent-Subsidiary Directive. In 2001, the European Commission issued a communication[10] "Towards an Internal Market without tax obstacles" where it pointed out problems related to the taxation of dividends not covered within the Parent-Subsidiary Directive. In 2003, the Commission issued a communication[11], which concerned the taxation of

[8] Sheppard, L.A., News Analysis: Pending Cases in the ECJ. 21.10.2008. TaxAnalysts, [http://www.taxanalysts.com/].

[9] For example, the Commission has started infringement proceedings in relation to taxation of dividends against Germany, Estonia and the Czech Republic (IP/08/143 of 31 January 2008), Czech Republic, Denmark, Spain, Lithuania, the Netherlands, Poland, Portugal, Slovenia and Sweden (IP/07/616 of 7 May 2007), Italy and Finland (IP/07/1152 of 23 July 2007), Luxembourg (IP/06/1060 of 25 July 2006), Germany and Austria (IP/07/1152 of 23 July 2007), Latvia (IP/07/66 of 22 January 2007).

[10] Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee – Towards an Internal Market without tax obstacles – A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities COM(2001) 582 final Brussels, 23.10.2001.

[11] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee – Dividend taxation of individuals in the Internal Market /* COM/2003/0810 final */

the dividends paid to individuals[12]. According to the communication, an analysis of the case law of the European Court of Justice makes it clear that EU Member States' tax systems should not hinder individuals from investing in foreign shares. Member States cannot levy higher taxes on dividends from companies in other Member States than on domestic dividends and, similarly, they cannot levy higher taxes on outbound dividends than on domestic dividends[13].

ECJ case law

There have been several ECJ judgments within recent years, which concern discrimination related to the taxation of dividends paid to non-resident shareholders. Some of the most relevant cases are the following: Fokus Bank ASA (EFTA Court – E-1/04), Denkavit Internationaal BV (C-170/05), Bouanich (C-265/04), Metallgesellschaft Ltd and Others (C-397/98 and C-410/98), Amurta (C-379/05).

In Fokus Bank case, the EFTA court stated that a difference in treatment can only be regarded as compatible with Article 40 EEA, where the situations at issue are not objectively comparable, or where it is justified by reasons of overriding public interest.[14] In Estonia, income tax withholding was applied to dividend payments to non-resident minority shareholders, because non-residents could not be subject to the Estonian corporate income tax as resident legal entity minority shareholders. Still, it could be assumed that the situations of non-resident and resident minority shareholders were comparable, but such a technical reason was not enough for justification.

The Denkavit case concerns a Dutch company challenging the validity of the previous French dividend withholding tax regime (before the Parent-Subsidiary Directive became applicable). The regime substantially exempted from withholding tax the dividends distributed to French parent companies, but subjected outgoing dividends distributed to non-French parent companies to withholding tax. The court found that less favorable treatment of non-French companies is a clear, unjustifiable restriction on the freedom of establishment. Still, the court stressed that the taxation effect of a double tax avoidance treaty must be taken into account

[12] Dividend taxation of individuals in the Internal Market

[13] Commission to tackle tax discrimination against foreign dividends, IP/04/25, 8 January 2004, Available: http://europe.eu/rapid/

[14] Fokus Bank, paragraph 28.

when determining whether domestic rules are compatible with the EC Treaty. The court concluded that *Article 43 EC and Article 48 EC preclude national legislation which imposes, only as regards non-resident parent companies, a withholding tax on dividends paid by resident subsidiaries, even if a tax convention between the Member State in question and another Member State, authorizing that withholding tax, provides for the tax due in that other State to be set off against the tax charged in accordance with the disputed system, whereas a parent company is unable to set off tax in that other Member State, in the manner provided for by that convention*.

In the case of Denkavit, the ECJ held that in the event that income tax is withheld on dividend payments to non-residents and the latter cannot use this income tax as tax credit in the country of residence, then this is also considered as an obstacle to the free movement of capital. In case of Estonia, there could have been discrimination if the non-resident could not use income tax withheld in Estonia for tax credit in their country of residence. On the basis of this ECJ decision, it may be concluded that the purpose of the free movement of capital should be to protect the residents of the member states of the EU from any discrimination, but it should not necessarily be to protect third-country residents investing in member states[15].

In the *Lasertec* case (C-492/04) the ECJ clearly concluded that the freedom of establishment (Article 43 of the EC Treaty) couldn't be relied on in a situation involving a company in a non-member country. Considering that the territorial scope of the freedom of establishment is restricted to the EU member states, whereas the free movement of capital would generally apply also to third countries, the Court did not comment on the standstill clause or any other third country related restrictions. The Court explicitly stated that the objective of Article 43 et seq. EC is to secure freedom of establishment for nationals of member states and not for those of third countries. Referring to a number of recent cases, such as Cadbury Schweppes and the Test Claimants in the Thin Cap Group Litigation case, the ECJ stated that holdings having influence on the decisions of a company concerned, and allowing the shareholder to determine its activities, come within the material scope of the freedom of establishment, and would therefore not justify an examination in the light of the free movement of capital (Article 56 EC). Whereas in Estonia, income tax withholding was applied in the case of minority shareholding, it could be concluded that such a withholding restricted free movement of capital, which must be ensured also in relation to third countries.

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[15] Delaurière, J. (2007). News Analysis: Does Denkavit Signal the End of Withholding Tax? – TaxAnalysts. [http://www.taxanalysts.com/].

In the *Bouanich* case, the court found that even bilateral double taxation avoidance treaties cannot justify the discrimination of non-residents in a situation comparable to the situation of the resident taxpayer. Even if a double tax treaty provides for a reduced tax rate, the refusal to grant non-residents deductions from the tax base might constitute discrimination, if the resident taxpayer had paid less in a comparable situation. Therefore, it may be concluded that the ECJ examines both the tax rate and tax base applied in order to decide regarding the discrimination of non-residents. In Estonia, the tax base applied in the case of non-resident and resident minority shareholders was the same, but the tax rate could differ because of the decrease of the income tax rate.

In the *Gerritse* case (C-234/01), the ECJ concluded that while the ultimate tax burden of the non-resident is not more than the tax burden of the resident in a comparable situation, the tax base and tax method may be different (e.g. a progressive tax rate in the case of a non-resident and a progressive tax rate with a tax-free allowance in the case of a resident – as described in the Gerritse case). In Estonia, non-resident minority shareholders were subject to withholding tax, whereas resident minority shareholders were subject to corporate income tax in relation to the redistribution of dividends received.

In the *Metallgesellschaft* case, according to the court, a cash flow disadvantage in comparison with a resident and non-resident is a breach of freedom of the establishment. In addition, the ECJ has stressed in the *Scorpio Konzeretproduktionen* case (C-290/04) that in the event that a resident is taxed on the basis of his/her net income, also a non-resident must have the right to deduct business expenses, which are directly linked to his/her activity in the Member State. Otherwise, any procedure involving additional administrative and economic burdens is considered as an obstacle to the freedom to provide services (Articles 59 and 60 of the EEC Treaty), unless the procedure is inevitably necessary to the provider of services. Thus, the ECJ has found in these judgments that discrimination on the basis of cash flow is precluded. On the basis of these two judgments, it may be concluded that the cash flow difference found in the Estonian tax system in relation to dividend payments to residents and non-residents, was not acceptable to the court.

In the *Amurta* case, the ECJ decided that the Dutch levy of withholding tax constitutes a restriction on the free movement of capital, since it treats non-resident shareholders less favorably than comparable resident shareholders. This restriction cannot, as a general rule, be justified. The Amurta case now further clarifies that

only a possible relief under a double tax treaty should be taken into account in this respect. A possible relief based on national tax law should be disregarded.

On the basis of these ECJ judgments, it may be concluded that the major problems related to the Estonian taxation of outbound dividends was related to the following issues:

- cash flow timing,
- applicable tax rate (in some cases),
- tax exemption for residents (in some cases).

These ECJ decisions gave sufficient reason to assume that the Estonian income tax withholding on dividend payments to minority non-resident shareholders, which were non-residents, was a restriction of the movement of capital.

Estonian Income Tax Amendments from 2009

On March 26, 2008, the Estonian Parliament adopted a draft law No. 181 SE[16] abolishing income tax withholding upon all dividend payments to non-residents as of January 1, 2009. According to the above-mentioned law, Article 29 (8) of the Estonian Income Tax Act regarding the taxation of dividends paid to non-resident legal persons for minority shareholding was to be cancelled from 2009. Still, before this law could even become effective, a new draft law No. 352 SE[17] was proposed by the Government on August 25, 2008 that was supposed to postpone the above-mentioned amendment by one year (i.e. to be effective from 2010), and to decrease the tax exempt holding size from 15% to 10%, as required by the Parent-Subsidiary Directive from January 1, 2009. Still, before the second reading of the new draft law No. 352 SE by the Parliament, the draft law was amended to abolish income tax withholding on all dividend payments to non-residents from 2009. This draft law was adopted[18] on November 20, 2008 and became effective from January 1, 2009.

Estonia has abolished income tax withholding upon dividend payments to non-resident legal persons who hold less than 15% of the share capital of the distributing

[16] Law Amending Income Tax Act, 26.03.2008, published in State Gazette RT I 2008, 17, 119.

[17] Draft Law Amending Income Tax Act No. 352 SE; Available at www.riigikogu.ee.

[18] Law Amending Income Tax Act, 20.11.2008, published in State Gazette RTI 2008, 51, 286.

company from the year 2009. The abolishment of income tax withholding on dividend payments concerns not only shareholders from the EU member states, but also from third countries and even from low tax rate territories. Thus, also the requirement to apply income tax withholding on any dividend payment to legal entity shareholders from low tax rate territories, irrespective of the size of their holding, are null and void from 2009. Thus, from 2009 there is no income tax withholding on dividend payments to non-residents in any case. Therefore, it could be concluded that Estonia has made all the necessary amendments in its domestic legislation to eliminate the provision discriminating minority non-resident shareholders upon dividend payment.

Still, in the event that a non-resident legal person cannot use the Estonian income tax withheld on dividend payments before the year 2009, as a tax credit in the country of his/her residence, such a non-resident or an Estonian company distributing dividends before 2009, may challenge the Estonian income tax withholding on dividends prior to the year 2009, as discriminative and hindering the free movement of capital. Therefore, it may be concluded that Estonia has removed discriminative provisions related to income tax withholding on dividend payments beginning from 2009, but this does not cure historical discrimination applied in respect to non-resident minority shareholders.

Conclusion

Historically, Estonia has applied income tax withholding on all dividend payments to non-resident legal persons holding less than the statutory minimum participation (15% in 2007-2008). Usually tax treaties decrease the income tax withholding rate, but do not cancel the withholding. In addition, all dividend payments to legal entities from low tax rate territories have been subject to income tax withholding irrespective of the size of the holding. In the case of a dividend payment to a resident person, no withholding has been applied, but in the case of a resident legal entity minority shareholder, the latter has been subject to corporate income tax upon further distribution of dividends received for a minority shareholding. Therefore, additional taxation of dividends has been applied also in the case of a resident legal person minority shareholder, but differences may occur in cash flow, tax rate and factual tax exemption. On the basis of several ECJ decisions, it could be questioned whether non-resident legal entities holding a minority of shares are discriminated against? Such an assumption is assured by the infringement procedure against Estonia in relation to the discrimination of dividend payments to non-resident pension funds initiated by the EU Commission in January 2008.

Taking into consideration the aforementioned, Estonia had to change the taxation of the income of non-residents in respect to dividends from portfolio investments. It is evident that the legislation applicable until the end of 2008, whereby income tax was withheld on dividend payments to non-resident minority legal persons, whereas in the case of similar residents there could be no equal further taxation, was not in accordance with the EC Treaty. Therefore, the Estonian Income Tax Act infringed on the fundamental freedoms of the EC and needed to be changed from 2009. Still, non-residents who were discriminated before the income tax withholding on dividends is cancelled, may have a chance to dispute income tax withholding in Estonia even after income tax withholding on dividends was abolished in the country from 2009.

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SECTION III: ECONOMICS, HUMAN RESSOURCES AND INSTITUTION DEVELOPMENT

Finding the Light to Exit Plato's Cave

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Introduction

In my article that was written in early 2004 (O'Neil 2005) I opened by discussing the data that constituted the concrete conditions of capitalism by comparing the nature of the data to the conditions that existed in the 1930s. In this article, as well as in the article that was written in Spring 2006 (O'Neil 2007), I discussed the qualitative transformations that had taken place in the capitalist economy between and within the periods of the Bretton Woods Golden Age (1945-1973) and the contemporary period of Globalization (1980-2009). Beginning in August 2007 and especially since Fall 2008 this qualitative change in the functioning of the capitalist economy has become obvious to all concerned observers and even mainstream economists are recognizing such a change. They have labeled it accordingly as the "Credit Crunch" that threatens to reproduce the conditions of the Great Depression of the 1930s. A perusal of Martin Wolf's presentation of the data in his *Financial Times* articles demonstrates the validity of this apparently sudden historic rupture with past activity. In 2004, after having reflected upon these conditions as they had developed especially after 1993, I called this transformation Debt Culture (O'Neil 2005) and maintain that this conceptualization, as elaborated there and in O'Neil (O'Neil 2007), is further supported by the data as it has become manifest in the last three years. Alternatively, "Credit Crunch" as coined by mainstream economists, is a tacit confirmation of Debt Culture. This article shows how economic, financial and political practice demonstrates Adam Smith's principle that labor is the cause of wealth and value.

I. The Economist, the Financial Times and a Presidential Advisor on Causation of these Conditions

The two publications express the views of many economists and capitalist enterprises. Their positions, regarding causality, tend to be either:

1) too much government regulation;
2) or too little via the deregulation of the finance industry.

Either cause had led to imbalances in the global economy. President Obama's advisor however, states quite bluntly "…even the experts don't know…what's going on…" (Volcker 2009). Volcker was a former Federal Reserve chairman. Martin Wolf expresses viewpoint (1), "…so what should be done? Some would argue: nothing at all. The view is widely held, particularly in the US, that the world needs a big purge of past excesses. Recessions, on this line of argument, are good. People who hold this view also argue that governments caused all the mistakes. The market would, they insist, be incapable of the errors we have seen…" (Wolf 2008). His wavering between (1) and (2) is apparent when he says, "…the chances of igniting a surge in borrowing now are close to zero. A recession caused by the central bank's determination to squeeze out inflation is quite different from one caused by excessive debt and collapsing net worth. In the former case, the central bank causes the recession. In the latter, it is trying hard to prevent it…" (Wolf 2009c).

Wolf epitomizes the vacillation of many "experts" when he says "…the market is absolutely wonderful but it can't be allowed to run on its own…"; but governments can go wrong too. "Judgment" is needed since we "can't obliterate" these conditions because they are a natural part of capitalism. We can't "…abandon globalization..." but just need to "…manage it better…". This seems to be a mix of positions (1) and (2). It seems that "…investors wanted higher returns than were available…" and thought that they "…could be fabricated synthetically...". It all seemed so "natural" at the time. People make mistakes but we "can't stop lending…", rather we must "…lend prudently…". However, we shouldn't lend to those who "…can't service the loan...". My impression from listening to this interview was that human nature seems to be the principal cause according to Wolf (Wolf 2009e). The explanation is that people aren't perfect and mistakes happen: "…people can make big mistakes, particularly if they confuse bubbles with permanently high prices…" (Wolf 2009a); "…the crisis had much to do with mistakes its policymakers and private institutions made…" (Wolf 2009b); "…if we want banks to make new loans, it makes far more sense to guarantee those, rather than bail out all those who financed the mistakes of

the past…" (Wolf 2009d). Wolf cites Alan Greenspan – a former Federal Reserve chairman – as saying 'I made a mistake…' (Wolf 2008). Greenspan himself said, "…I don't think we forecasters have been factoring in innate human nature… we repeat the same thing time and time again…we cannot learn…" (Greenspan 2007).

The survey article of January 2009 in *The Economist* (as author) likewise expresses skeptical vacillation between positions (1) and (2) suggesting it can all be chalked up to irrational human nature that renders causality a mystery. They say, "…what else but madness could explain all those overpriced Dutch tulips…cupidity, fraud and delusion were obviously part of the great bust. But if they are the chief causes of bubbles…you have to suppose that civilization is beset by naivety and manic depression…when reasonable, self-interested people trade with each other, optimism tends to breed optimism—until it subsides into corrosive pessimism… bubbles sometimes get out of hand…the case for regulation, in a nutshell, is that financiers make mistakes and everyone else has to pay for them…the regulators have the legal power. But the financiers have the political power…well-connected people…usually get their way…the repeal of the Glass-Steagall act, a Depression-era separation of investment and retail banking…has since come under attack as the sort of 'market fundamentalist' project that caused the bubble. However, the supporters of the repeal argue that it was really a first step towards modernizing a system, which had outgrown Glass-Steagall…The problem was not so much deregulation but regulation's failure to evolve with the so-called "shadow banking system"… (The Economist 2009).

The implication of the aforesaid is nothing less than a form of philosophical skepticism that dismisses the ability of human reason to coherently grasp the nature of the most profound economic crisis witnessed since the Great Depression. Both Volcker and Greenspan suggest that the cause is unknown and unknowable. In contradistinction to such skepticism that we can't learn, I have maintained that there is rational explanatory causation in political economy: financialization – or what I have called the Proclivity to invest in financial assets – arose from the tendency for general profitability on productive capital to decline and precipitate crises. The decline is a consequence of increasing labor productivity. This decline has always been a feature of the capitalist economy from which learning can take place when the methodological focus is placed upon the underlying essence that causes appearances in social nature; it was what guided the science of Adam Smith, David Ricardo and Karl Marx. *The Economist* titled a section of their January survey "Plato's Cave" without indication as to why they chose to use such a metaphor or

how this classic allegory has relevance to the conditions arising from Debt Culture. I avail myself of the opportunity to compensate for this lacuna in order to illustrate the necessity to attain a proper methodological focus that can advance human understanding of the acute condition in which the species finds itself.

II. Plato's Cave

In this cave there are no prisoners who are forced to be there via any kind of physical coercion. All of the inhabitants of the cave, when asked, consciously express their opinion that they are there as a consequence of their own volition. They consider themselves to be free individuals pursuing their own self-interest independently of any of the other prisoners. There is no conception that any aggregate population of the totality of the prison population exists: all perceive themselves as self-subsistent individuals who only know the images emanating out of the monitors to which they have voluntarily chained themselves. The dialogue takes place between Socrates (Soc) and a representative agent (RA) of the prisoners whose perceptions and preferences homogeneously constitute those of all the other prisoners. The prisoners agree that due to this homogeneous property of perceptions and preferences a pre-established harmony exists between them and consequently our RA can speak for them because they are preoccupied with the images arising out of their monitors. A minority of the other prisoners considers that the RA is incurring an opportunity cost via talking to Socrates because Socrates asks too many questions and this distracts them from the fixation upon their monitors. However, the majority of the other prisoners assure the minority that because the RA has perfect foresight the integrity of the pre-established harmony will not be disturbed.

Scene One

Soc: What are these images upon which you and the others are fixated and why do you spend so much time observing them?

RA: They are prices. I consume so much of my life observing them because I derive pleasure from doing so.

Soc: How does this activity provide you with such pleasure?

RA: The activity is only a means to an end so that actually it's this end that gives pleasure.

Soc: And what is this end?

RA: To consume objects of utility.

Soc: What are these objects of utility?

RA: These are the direct source of my pleasure. Myself and the other prisoners, I mean agents, call them consumer goods.

Soc: Thus the prices emanating from the monitors only indirectly symbolize these objects of utility?

RA: Yes. They are the forms of manifestation or impressions given by my senses that express the utility or pleasure derivable via consuming the objects of utility. I heard some philosopher call them sense data. But after a long day staring at them they cease to make sense to me. But I must come back the next day to get the cents I need to obtain the necessary objects of utility. Excuse the pun.

Soc: So where does this utility exist or come from?

RA: What? I don't understand the meaning of this question. Its origin does not concern me. My only concern is that it exists in my senses and it makes me happy.

Soc: But do you consume the prices or the objects?

RA: I've already told you that I consume the objects. I can't consume prices since they are only sense data or impressions emanating from the monitor.

Soc: Then, does this mean that the sense data are caused by the objects?

RA: Socrates you are beginning to annoy me. The others warned me about your persistence in asking so many questions. As I have said origin and cause are not germane to our activity.

Soc: If the prices can't be consumed then how do you obtain the objects whose utility is expressed by the prices?

RA: I use money. The money is the unit in which the prices are measured.

Soc: Then you exchange a given quantity of money for a given object of utility?

RA: Yes.

Soc: Does then this constitute an exchange of equivalents that then enables you to derive the utility that makes you happy?

RA: Yes.

Soc: Then money, in itself, provides you with no utility but is only a symbol of price?

RA: I am not concerned with what the money is in itself since it's only a means to derive utility.

Soc: Yes now I understand. I also understand that it would further annoy you and perhaps antagonize you if I were to ask you where the money comes from.

RA: You are correct Socrates. However, just to indulge your curiosity, my understanding is that banks and government create money. This must be true because I get my money from the bank in order to buy my objects of utility and the bank is getting it from the government of our new President Obama; but again the issue doesn't rally concern me because I have heard that even scientists are no longer interested in addressing such questions as origin of the new, causation, or generation of processes in Nature.

Soc: Therefore, these scientists are not interested in how government can create money out of nothing so that banks and consumers like yourself can engage in your pleasurable activities?

RA: You are again correct Socrates. Finally you are beginning to understand the creation of these objects of utility and the money to buy them with is really not an issue of concern to anyone!

Soc: I am concerned since myself and others must pay taxes to finance government activities. So if you don't mind there are still a few points that require clarification.

RA: Ok but I really must get back to my monitor since I am foregoing excellent trading opportunities.

Soc: You have said that the consumer goods are the direct source of your pleasure and that the money provides no pleasure in itself, correct?

RA: Yes.

Soc: Since you've already stated that the consumer goods are the direct source of your pleasure, can you then further agree that having the money is an indirect prerequisite to your ability to experience the sense data called pleasure and that since the money is such a prerequisite then it follows that the utility must be a property of the consumer goods you so cherish?

RA: Yes.

Soc: Then it must be true that the experienced sense data or impressions called pleasure are distinct from the property of the consumer goods known as utility?

RA: Yes this must be so.

Soc: Must it also be so that since the money is only an indirect means that measures price or exchange value, and that, as you have said, the exchange of good for money constitutes an exchange of equivalents it would then follow that the

utility or use-value of the good is a prerequisite to its exchange value or price expressed in units of money.

RA: Yes Socrates I am beginning to follow your logic in this regard.

Soc: I myself must agree with you that none of that which we have discussed and reached concordance upon has required us to address the issue of what is the origin of these goods or objects of utility. Moreover, since the exchange of goods or use-values for money constitutes an exchange of equivalents there is nothing in which we have discussed thus far that would indicate the proportionate magnitude that is required in this exchange of equivalents.

RA: I do not understand what you mean by proportionate magnitude.

Soc: This is the magnitude or quantity of money that is necessary in order to buy, say, one unit of use-value or utility.

RA: You mean for example that I can buy a Jonas Brothers DVD for my child for $20?

Soc: Yes that is exactly what I mean. Furthermore, can you also agree that since the money, as the unit that expresses price, is only an indirect means of acquiring the object – whose qualitative property is utility – then it follows that price – unlike utility – is not a quality or attribute of the goods which you so cherish.

RA: Yes I can agree to that.

Soc: Since we have reached agreement may I ask further indulgence via requesting another lunch date tomorrow since there are additional points of curiosity regarding your activity that I would like to pursue.

RA: Yes since you have been polite and respected my lack of concern for causes and sources of origin I can grant you one more lunch date. However, you must agree this will be the last one.

Soc: We have reached agreement. Thank for your time, until tomorrow then.

Scene Two

Soc: Thanks for meeting with me again today. There are only a few more questions that I seek to clarify before you return to your trading activity. I heard that you went out and bought that Jonas Brothers DVD for your son. Did he like it?

RA: Thank you for asking. Yes he did. It really amazes me how young people today are always tuned into their electronic devices. I can't seem to separate him from them, it seems that they exist as one being.

Soc: Yes, I agree. I must also say that this is quite a profound insight on your part.

RA: Maybe so Socrates but let us not forget that we agreed to avoid getting into any type of profundities.

Soc: That we did. I was curious as to how you get the money to buy such necessary objects of utility?

RA: My boss credits my bank account each week and I use the ATM or debit card to make such purchases of necessities.

Soc: Hold on, must you not produce something first for your boss.

RA: Not really I just sit at my screen and follow the order book.

Soc: What is the order book?

RA: This is a list of price ranges for the trades we make. I just observe the images of prices coming from the monitor and when I see a deviation from the range I make a trade. There is a list for consumer and producer goods – or commodities – that shows prices in different parts of the world and a list for securities that does the same.

Soc: Wow! This activity must require a lot of thought.

RA: Not at all if I think too much a trading opportunity will pass me by and I could lose my job. I was told as a condition of my employment to leave the thinking to others working in the research department. I must admit, however, that things got more complicated after 1973 when all these exotic securities were introduced.

Soc: How so?

RA: The exotics have underlyings which are hard to identify and thus imply profundities beyond my concern. The mathematical experts – Black and Scholes – thought up these exotics and the statisticians create the range of price impressions that constitute the order book. In the past, when there were just commodities the rule was basically to buy low and sell high. But now we can also do the reverse when we short sell via use of the exotics. It used to be that I could only get my account credited when the market moved up but up until recently the same could also happen when the market went down.

Soc: The so-called Credit Crunch has changed this?

RA: Yes. Many of the other traders have lost their jobs as a consequence. I have wondered what happened and yesterday, after having talked to you I suspected that it must have something to do with the fact that neither myself, nor other traders, nor other consumers actually consume these exotic securities

called derivatives. They give me no utility and I heard that companies do not consider them to be directly useful in their operational activities either. Likewise the experts who created them disagree regarding their capacity for value creation.

Soc: So previously the source of both your boss' income and your own was contingent upon the easy flow of liquidity – arising from excessive debt creation -that preceded the Credit Crunch?

RA: Yes. This was what enabled us to construct our trading strategies and had led to the realization of the pre-established harmony that the *Economist* called Equity Culture.

Soc: Thanks so much for your time and say hello to your wife and son for me. I hope the pre-established harmony returns soon.

RA: You are welcome. I hope so too. President Obama has promised that his new government's creative stimulus activity will soon re-create the pre-established harmony. I have enjoyed our conversation because not many people have shown much interest in the nature of my activity but you took the time to show interest and I appreciate that.

II. A. Commentary on the Dialogue

In this dialogue we see the present incarnation of Socrates attempting to persuade the recalcitrant RA to consider the underlying foundation or basis for his/her activity. We can see that Socrates was only incompletely successful in this endeavor.

The RA should be recognizable to modern workers engaged in intellectual and practical activity in economics and finance: the structure of market activity is taken as given, or is known by the agent /practitioner, and all that is needed is to rationally react to the impressions issuing from the monitor according to his/her information/expectations deriving from that structure.

Socrates was able – via his technique of dialectic – to elicit from the RA some important insights that even the RA himself/herself did not previously conceive but always implicitly knew. These intuitions (I) are: I1) money has no utility in itself but is just a symbol of price or exchange value; I2) that price is not consumed but the consumer goods are, so that while utility is a property of the goods, price is not such a property; I3) that the money, as a symbol, measures the units of price and is used to transfer or circulate the goods/securities between buyers/sellers; I4) that

in this circulation equivalents are exchanged; I5) that the perceptions or sense data expressing utility appear to be distinct from the use-values themselves; yet these use-values are nonetheless necessary components of the being of the consumers; I6) that, conversely, the exotics or derivatives have no utility for consumers nor firms in their operations; I7) that the exotics are created by the mental labor of financial practitioners; I8) that there must be something that underlies the price at which the goods/securities exchange in the market or sphere of circulation: given by the example of one DVD = $20.

Socrates, however, was unable to extract any of the following – let's call them the shadows or mysteries (M) that underlie the impressions that emanate from the monitor – from the RA regarding:

M1) the source from which the objects of utility appear in the market or sphere of circulation;

M2) any understanding that explains the cause of the magnitude at which the goods/securities exchange with money;

M3) the nature of money in itself – since it has no direct utility according to I1 – and where it comes from other than the impression that banks/government can create it;

M4) how the exotics – unlike the consumer and producer commodities – can have a price without having any direct utility to consumers or firms in their operations.

While M (1) – M (4) arose out of the questions that Socrates was warned against pursuing as a condition for further dialogue, another mystery arises – M (5) – out of a question which Socrates himself did not consider asking: or refrained from asking due to the reluctance of the RA to respond to questions considered to be too profound. We may forgive him for not thinking of it because it was a perplexity that was only addressed subsequently by Aristotle. Specifically, M (5) arises out of the income generating activity of the RA via buying/selling or selling/buying of goods (commodities), securities, or derivatives (exotics); if there is a gain made from such activity then it would seem to contradict both I1 and I4: since it would seem that there is a use value or utility attached to money and that the gain or profit that arises would imply that equivalents are not exchanged.

These mysteries seem to be quite complex and like the shadows in Plato's cave – whose cause remained indeterminate as long as the prisoners remained in the cave – their substantial nature will remain ambiguous as long as the focus of

attention confines itself merely to the sphere of circulation of the goods/securities. Simultaneously, the intuitions uncovered by dialectic are the embryos capable of emanating light that can lead one out of the cave of circulation; however, it must first be considered whether the method of economics can provide a similar light to exit the cave.

II. B. The Methodology of Economics or the Complexity of Causality

"We are living in a difficult time for the economy, with unprecedented complexities, complications and risks for financial markets and financial institutions…" (Volcker 2009b). This section gives a summary treatment of the claims of neoclassical economics, or simply economics, to scientific status. Three sources are considered representative: Daniel Hausman, John Stuart Mill and John Neville Keynes. The focus is upon causation as the fundamental scientific principle.

I consider two articles by Hausman, one from 1998 and the other from 2008. Hausman (Hausman 1998) warns us "…economists are wary of causal language because of its suggestion that outcomes have single causes…". He says "…orthodox economics…poses interesting puzzles…the success of orthodox economics is controversial…" because "…classical economics, like contemporary theory… had empirical difficulties… the rate of return in the 19th century did not fall sharply, and wages increased dramatically…" Hausman implies that empiricism and science are synonymous when he says that there is a "…conflict between empiricism and economics, which arises from the apparent disconfirmations of economics and the difficulty of testing it…" This he calls "Mill's problem." The problem is that "… economic phenomena depend on many causal factors that are left out of economic theories. Consequently, the implications are *inexact*... " Due to a "…multiplicity of causes… there is no way to incorporate a much larger number of causal factors…" Economics "…is unavoidably a science of 'tendencies' only…" The message seems to be that economics is unlike the natural sciences, where controlled experiments are thought to be able to precisely isolate causal relations, making them exact sciences. Mill's problem is then the impossibility of this in social science. Hausman proceeds to analyze methodological developments since Mill, concluding that "… economics presents a tantalizing list of puzzles; with Mill's problem at the core… there is much that is unknown and puzzling about how much people can learn about the character of their interactions…" This is just philosophical skepticism because I had reached similar conclusions regarding the "puzzles" yet did conclude that it demonstrated the anti-scientific nature of economics (O'Neil 2005). Hausman

(Hausman 2008) reiterates, "…current methodological practice closely resembles Mill's methodology…" and that unlike current economic method, he is concerned "…with underlying causal mechanisms…a century ago economists talked of their work in terms of 'principles,' 'laws,' and 'theories.' Nowadays the standard intellectual tool or form is a 'model.'…what are models?…" This is a more commendable conclusion because it demonstrates intuition that scientific practice does not exist within economics.

Economic models deny the existence of a general rate of profit so that there can be no notion that its movement can be the cause of the crises of the 19th century – let alone those of the 20th and 21st centuries (O'Neil 2005). Hence another puzzle – "Mill's problem"- is posited. As Hausman suggests there did exist a more principled, conceptually based approach deriving from Ricardo's conscious effort to reconcile Smith's intuition that labor is the cause of value to the appearance of price in circulation. Ricardo and Smith were adherents of Enlightenment thought, conceiving science as being able to free production of wealth from any unnatural, socially imposed restrictions; or that judicial social laws conceived by the human mind can and must conform to natural laws. Mercantilism and the Corn laws prevented such conformity. Conversely, Mill's problem arose because "…in all the intercourse of man with nature, whether we consider him as acting upon it, or as receiving impressions from it, the effect or phenomenon depends upon causes of two kinds: the properties of the object acting, and those of the object acted upon. Everything which can possibly happen in which man and external things, are jointly concerned, results from the joint operation of a law or laws of matter, and a law or laws of the human mind. Thus the production of corn by human labour is the result of a law of mind, and many laws of matter…the law of mind is, that man desires to possess subsistence, and consequently wills the necessary means of procuring it. Laws of mind and laws of matter are…dissimilar in their nature…" (Mill 1844). The objects acted upon, use-values of production (tools) and consumption (goods) and the acting subject – the material and mental components of productive consumption – are seen as dependent upon different causes rather than upon each other. Consequently, production is an act of mind, desire and will: not the time of consumption of the use-value of human activity – as in Smith, Ricardo and Marx. These causes are in striking "contradistinction" and since experiments aren't possible "…it is vain to hope that truth can be arrived at…in Political Economy…while we look at the facts in the concrete, clothed in all the complexity with which nature has surrounded them…there remains no other method than the a priori one, or that of 'abstract speculation.'…." In any particular situation there are circumstances that "…have been called disturbing causes…here

only…an element of uncertainty enters into the process—an uncertainty inherent in the nature of these complex phenomena…arising from the impossibility of being quite sure that all the circumstances of the particular case are known to us sufficiently in detail…" The disturbing causes "…operate… through the same principle of human nature…the desire of wealth…in other instances the disturbing cause is some other law of human nature…" (Mill 1844). Mill's father said, regarding simultaneous wealth and value creation, "…why, or how, these effects take place, he is ignorant… it is matter itself, which produces the effect…" (Mill 1821, sec 1.3). The son expresses the same mystery because "…the physical part of the process takes place somehow" (Mill, 1844). Thus, "matter" (tools) " produces" not labor. Labor as cause is eliminated. In both Mills tools and labor are reduced to "natural agents" such that their "…ownership or use…acquires an exchangeable value…" (Mill 1848, bk.1, chp 1, sec. 4) (Aguirre 1962, 281). Things produce things: this is the source for both neoclassical and Neoricardian economics in the 19th and 20th centuries, respectively.

Mill (Mill 1851) offers a similar view, since in society "…the multitude of the causes is so great as to defy our limited powers of calculation." The result is that instead of building upon the positive side of Ricardo/Smith – labor as cause of value and wealth – and rejecting the negative side – the unhistorical a priori deductive method of Ricardo – Mill does the opposite and creates Positivism (a self-contradictory term): which claims there is no underlying essence (labor time) that explains market appearance (price). Marx opposed Mill via dialectically negating Ricardo/Smith: accepting the positive side and eliminating the negative side. Smith, however, was much less unhistorical than Ricardo.

Keynes differs only slightly from Mill by correctly saying that production is subject to social laws, concurring with the a priori method, yet calling the disturbing circumstances "predominating" and arising from "indisputable facts of human nature" that are influenced by the "desire for wealth" (Keynes 1917, 13). Economics is a social science, not moral as in Mill, and "…economic laws… are…laws of complex social facts resulting from simple laws of human nature…" (Keynes 1917, 46).

Thus, it's apparent that the source for the views of Wolf, Volcker, Greenspan and *The Economist* are firmly rooted in a sceptical foundation in the history of economic thought that separates the species connection with Nature – production – from its mental and social activity. The relation between the two is then an inscrutably complex phenomenon grounded in an eternal human nature that is subject only

to contingency or disturbing causes rather than social necessity. Some writers see cause (2) above as having eliminated a "time immemorial" regulation against usury; incorrectly suggesting that interest is an attribute of human nature rather than a historically evolved social relation (Hudson 2007) (Geoghegan 2009). Hudson (Hudson 2009) seems to base this on a presumed distinction between "earned" vs. "unearned" income that he considers to have existed in "classical economics" rather than the principled distinction between productive and unproductive labor that Smith characterized in the *Wealth of Nations* – whereby interest is a part of Smith's "ordinary profit" arising from productive labor.

III. Out of Plato's Cave

III. A. Substantial or Scientific Causality and its Origin

The founders of scientific thought – Socrates, Plato and Aristotle – built upon the work of their predecessors – the Ionians and Eleatics – to combat the trend in philosophical thought – Sophism – that attempted to confine thinking to the immediately perceptible, which maintained that if there is any truth then it can only exist in the realm of what appears to the senses. These initiators of scientific thought fought the Sophistic trend in order to provide a deeper conceptual understanding, based upon reason, which recognizes truth, or a necessary scientific law (the universal) that is united with observation of the particulars of sense perception. Scientific law in political economy then should necessarily explain the underlying essence, or value, of what appears to be true as given by the immediate impressions of the senses, or price. As I have already said (O'Neil 2005) science is a unity of both perceptual and conceptual knowledge. For example, in natural science the essential nature of planetary orbits is still in the process of being determined; while it took thousands of years for Kepler, Newton and Einstein to arrive at the gravity based explanation, this account is itself now being called into question in favor of an even more general or universal theory that accounts for the apparent phenomena of Nature as given by the measurable sense data (Thornhill 2008). This universal in natural science is the more fundamental, qualitative, form-giving or creative process known as plasma that underlies the observable phenomena that pervade the Cosmos. Don Scott calls plasma the "fundamental state of matter" (Scott 2009). An understanding of plasma is more essential because it is more powerful than gravity (Lerner 2006). In political economy, perceptual knowledge corresponds to the observable sphere of circulation or market activity while conceptual knowledge is constituted by an understanding of the process of production of the necessary objects of utility. Plato to a certain extent, and Aristotle, in a much more

fundamental manner, tried to show how conceptual thought could be concrete via explaining how what appears to be true via the particularity of sense perception has an actual underlying universal content in Nature. Aristotle recognized this underlying, unifying, causal power as existing universally, as actuality, in all natural substances that strive to realize the potentiality of their particular forms and called this formal or substantial causality. For Aristotle, this form giving power was the soul that corresponded to both "…the possession of knowledge and the actual exercise of knowledge…" (Aristotle, bk.II, sec 1) (Copleston 2000, vol.1, chp 29) (Windelband 1898, 260-4). Knowledge is not just thought but the unity of thought and activity in Nature. Likewise Smith, Ricardo and Marx looked for the same underlying process in the particular science of political economy to explain what constitutes the substantive nature of market activity as it appears in the circulation of money and goods. They too fought against the equivalent of a Sophistic trend, which always existed in the history of economic thought. Smith began the struggle against the deceptive appearances of the Monetary system, or Mercantilism, when it was much less complex than it is now. The Monetary system misconstrued the particular form of gold as universal wealth. Contemporary capitalism only differs in the range of complexity of the various forms of circulating money. My work only seeks to continue the effort to unveil the mysteries that are presented to the senses by these complex monetary forms. Thus, just as the underlying essence of the understanding of the nature of celestial motion continues to develop, so does the understanding of the nature of value relations and their manifestation in the various monetary forms via market price. Hence, as Engels said, new developments in philosophy and the particular sciences are driven by innovations in the natural sciences – especially physics (Engels 1878).

John Stuart Mill was the incarnation of the Sophistic trend in political economy. He could never overcome the mentoring he received from his father who built upon the weaknesses and confusions implicit in Ricardo's theory of value. Ricardo himself, in his review of James Mill's *Elements*, pointed this out to James: "what I call exceptions and modifications of the general rule you appear to me to say come under the general rule itself" (Ricardo 1821). Consequently contingency usurps necessity in value theory such that Stuart Mill's consideration of the two spheres of production and mind as being absolutely distinct, and his confinement of causality to the sphere of the senses via the elimination of any notion of material substance, led to the degeneration of classical political economy in its ostensible Ricardian form: thereby providing the groundwork for the transition to neoclassical economics. The manifestation of this in economic theory is: 1) the "substitution effect" in portfolio theory whereby productive capital doesn't exist in economics

– as discussed in O'Neil (O'Neil 2005). The consequence is that production or the mass of use-values is taken as given, and 2) price (equals value in economics) is just a manifestation in the mind of a hidden cause deriving from these given objects of utility. In Mill's own words from the *System of Logic*: "Body having now been defined the external cause, and (according to the more reasonable opinion) the hidden external cause, to which we refer our sensations; it remains to frame a definition of Mind…as our conception of a body is that of an unknown exciting cause of sensations, so our conception of a mind is that of an unknown recipient, or percipient, of them; and not of them alone, but of all our other feelings. As body is the mysterious something which excites the mind to feel, so mind is the mysterious something which feels, and thinks… on the inmost nature of the thinking principle, as well as on the inmost nature of matter, we are, and with our faculties must always remain, entirely in the dark…" (Mill 1851, I, 3, 8). Here, body represents use-value and the sensations became the constituents of price in the birth of neoclassical economics after 1870. The sensations are those pleasurable feelings that make the RA happy, or subjective utility. So that both production and the mind that experiences the sensations that result in price are both mysteries such that any law of causality only exists in the sphere of the senses – circulation – without any necessary connection existing in production since we are in the dark regarding its inmost nature. Mill intended "…to determine the concept of causality only in so far as it can be obtained from experience, he did not propose to introduce any notion of a mysterious necessary connection between cause and effect. Such a notion is not necessary in a theory of inductive science" (Copleston 2000, 80-3). That is, not necessary for Mill when science is limited to sensual appearance. Thus, it wasn't necessary to have a notion (conceptual thought) of production, the connection of man and Nature: since "matter" (what Mill called Nature) is only the "permanent possibility of sensation" (Copleston 2000, 92-4). Consequently, Nature and man's connection with it via production is seen only as potentiality – not as an underlying unity of potentiality and actuality as in Aristotle.

Using simpler words, in contradistinction to the trend of scientific thought as represented by Aristotle, Smith, Ricardo and Marx, according to the method inspired by Mill there is no underlying essence or actuality to market activity, any truth that may exist can only be grasped via restricting observation to the movement of goods/securities in the market or the cave of circulation. Causality is confined to quantitative correlations between these observations as constituted by the analysis of empirical data utilizing sophisticated mathematical/statistical techniques invented by intellectual workers within the social division of labor (social nature) but outside of the sphere of connection with Nature – being the

production of concrete use-value or wealth. Curiously, Thornhill, a physicist, can recognize the methodological problem of economics because it's the same problem that plagues his science: a priori mathematical deduction having no ground in Nature (Thornhill 2009). Likewise, Lerner recognized the social implications of financialization because he understands how ideas generated within society affects his own science of physics (Lerner 1991).

While Mill's view of substance (use-value) and causality came in a line of descent from Locke, to a certain extent, and Berkeley, Hume and Kant to a much greater extent, the view offered here descends from Spinoza, Hegel and Marx – both of which in the modern period came from Descartes and originally from the ancient Greeks. Whereas the former goes as far as denying the existence of both material and immaterial substance, the latter – as constituted in the present work – adheres to the common sense notion of the existence of material substance, or use-value, and the existence of an immaterial substance or value as a social relation having no particular material form. Here these two substances constitute different forms of Nature, which is itself one necessary universal knowable process: unlike for Mill where mind, or social relations, and body, or production of use-value, are distinct and a barrier is erected between mental labor, or the production of ideas, and the production of use-value or material production.

Although the second trend regarding substance is regarded as anathema by the majority of modern intellectual workers it is considered here to be the scientific trend because science requires connection with Nature: because we learn by understanding Nature and changing it for the purpose of survival. This is after all what production is and any mentally imposed disconnection from this source can only lead to mysteries and anomalies because as Plato's and Hegel's mentor – Heraclitus – taught us Nature is the Logos in which we must immerse ourselves otherwise we are asleep (Hegel, 1805-6). Plasma is the universal process that Heraclitus naively called Fire; thus, the logic required exists in this connection with Nature and here it is used to clarify both the above intuitions and the mysteries that arose in the cave of circulation.

From Hegel's *Science of Logic*: "…. Substance manifests itself through actuality with its content into which it translates the possible, as *creative* power, and through the possibility to which it reduces the actual, *as destructive* power. But the two are identical, the creation is destructive and the destruction is creative; for the negative and the positive, possibility and actuality, are absolutely united in substantial necessity…" (Hegel 1812-16,1239). While Hegel thought there was

only immaterial substance, my use is that the immaterial substance labor power – the capacity to work as use-value – is the creative power that transforms the material substantial necessity of Nature (possibility) into the necessary objects of utility (actuality) via the process of production resulting in both wealth creation and value creation. Labor power as activity is not labor as product. Power is the necessary causal connection with Nature that Locke unsuccessfully sought – hence my "certain extent" comment above (Locke, bk. 2, chp 21) (Tagart 1855). Labor power is immaterial because it is a homogeneous activity (work) that constitutes the essence of the species: all individuals must work to eat and eat to work. The objects do not exist in contradistinction as Mill thought. Thus, the RA had a correct intuition (I5) regarding his son and his DVDs. The mental and material creative power of labor power, as use-value, when consumed productively, causes both wealth (use-value of product) and value (exchange value or price as measured by money). As Hegel says there is ongoing creation and destruction presently occurring in both the social universe and the rest of the universe known as Nature. The plasma cosmologists recognize this latter process in Nature, which was not created by some initial mysterious Big Bang. An exchange between a capitalist and a worker leads to production or consumption of labor power. This production – transformation of Nature's possibilities into actualities for the species – creates new wealth and value and destroys the old use-value of the tools of production while mentally preserving the old exchange values (accounting prices of the tools and monetary portfolios). These accounting prices exist only in the head, monitors and spreadsheets and price tags of the RA and the other agents (workers in both circulation and production) of the capitalist economy who strive to realize them via the competitive struggle arising from the qualitative value relations of the society that they themselves have created: but now the workers in circulation are dismayed by their inability to find "value in the market". It's a mystery as to why all the fictitious "values" they created could disappear so suddenly.

III. B. Clarifying the Mysteries of the Cave

Plato thought that only philosophers and other members of the ruling elite who shared privileged positions in Ancient Greece could grasp the intuitions arising from the Socratic dialogues. The consequence was that his conceptual Forms, which were supposed to represent the universality of scientific knowledge, could never be brought down to earth to reside in the concrete particulars with which every one was familiar. However, we've seen that our RA was able to grasp these intuitions but his/her social position as a trader did not allow him/her time to ponder the underlying essence of his/her daily activity. My own experience as an intellectual worker has taught me that the social position of many such workers likewise limits

their curiosity regarding the nature of this simple equation of exchange appearing in the dialogue, since they take as given that which they need to explain.

According to the standard theory in economics the RA maximizes their utility subject to a constraint of income and that the sum of all such activities places a subjective valuation upon the goods which then appears as market price. The problem is that it assumes what it seeks to demonstrate. We have seen that the images that consumers/traders observe are prices; they are not the goods themselves. When people shop they compare prices (price tags): they can't consume the goods first then get subjective sensations from them and then decide which goods to buy thereby having their demand determine price. The prices are measured in units of money and in order to compare them both quantitatively and qualitatively they must already appear in a money or price form. When firms produce for the market they already have in mind a price. Likewise the consumers have a price in their mind at which they'd be willing to buy any objects of utility. Exchange is a change of form between two objects having the same underlying value: the value of the money (one object whose form is the general equivalent or exchange value) equals the value of the good (another object whose form is a use-value) for which it is exchanged. The money only has a use-value in that it effects this change of form: in itself it has no utility in the sense of an external object that can be consumed to provide necessary nourishment or shelter from Nature or subjective fancy such as fashion (utility is both objective and subjective). Money then is used to convert the products of agents' labors (non use-values for them) into their necessary use-values: thus it measures the equivalence between the objects and transfers or converts them from being non use-values for their owner or producer into being use-values for their new owner or consumer. If money is not spent it's invested (lent) and someone else uses it to effect his or her necessary changes of form (Marx 1867). The utility is a property of the good – it provides the agents with their necessaries (objective and subjective) and is a prerequisite to its appearance in the market as an exchange value measured in price. As in section III. A., not only are consumer goods necessary components of the RA's being but so are the tools of production: the objects and subject (sensation) are not distinct but necessary transformations of each other. The monitor is the tool that provides the sensations necessary for the RA's activity. Sensation, since it can only exist due to the nourishment stemming from consumer use-value, only appears distinct in I5 – in actuality it's not distinct. Thus, the first five intuitions (I1 – I5) of our RA were correct.

Jevons – the most influential founder of the subjective theory of value – considered use-value only as a sensation of the RA and following Mill considered the material

nature of the object of utility only as the possibility of sensation in the mind (Ekelund 1983, 314) (Burtt 1972). The origin for this idea is that – according to the first trend regarding substance – the object has both primary (1) and secondary qualities (2). Whereas for Locke (1) was an attribute of substance (the object) and (2) was not; for Berkeley, Hume and Mill neither (1) nor (2) were such attributes since they only exist in the mind. Thus, in the theory of value of economics a mysterious unknown quality of the good causes the sensation called price and this is considered to exist only in the minds of individual agents and is considered distinct from the objects. However, this is falsified by the correctness of I1 – I5 arising out of the practical activity of the RA.

Value as a social relation is unobservable in the market because it's not an attribute of the substance or use-value of the goods. Thus Smith, Ricardo and Marx distinguished between use-value and exchange value and referred to this unity of all these objects by calling them commodities – and labor power is one such object that is a necessary commodity for capitalism to exist. So when financial traders say they can't find value in the market they are right but for the wrong reason. Value is not in the market only price: they can't find a price to offload unwanted exotics, which have no price because they have no value because they are created in the cave of circulation and traded or exchanged between the agents of circulation where we've seen only equivalents are exchanged. Financial innovation leads to an exchange between two "capitalists" (traders) not an exchange of substance between labor power and money capital. Likewise, neither do consumer goods nor producer goods possess value in the sense that it is an attribute of their substance. Value is a qualitative social relationship that constitutes the underlying – living socially necessary labor time – that explains the equation of exchange of equivalents. The traders of derivatives know that each one of them – options, swaps, forwards and futures – has an underlying. However, what is not realized, both by those who have created them and those that trade them – because the nature of their social position precludes them from investigating either because they lack the curiosity or they are too exhausted by their daily activities staring at the monitors – is that these underlyings must themselves have underlyings. Therefore, they are not able to find the exit from the cave of circulation and they continue to be perplexed by the collapse of the pre-established harmony.

Thus, the light that can lead one out of the cave exists and has always existed. It's a Socratic and Platonic reminiscence, or a performance of old work consciously, of the long tortuous history of economic thought that began with Aristotle, Petty, Locke, Hume, North, Massie, and led to Smith's investigation of the causes of

the wealth of nations and Ricardo's attempt to rationalize the dual sided nature of Smith's labor theory of value. The pre-Smithians who contributed to the pre-scientific stage of political economy were necessary stepping-stones to Smith's scientific breakthrough. Many of them had rudimentary labor theories of value (Petty, Locke, Hume) and knew – if not in an explicit conscious manner then via unconscious intuition – that there was a difference between price and value: that value is the necessary or "natural" tendency around which market price is a contingent approximation – yet that the two never really coincide. Smith called that natural tendency the natural price and this became relative value and price of production in Ricardo and Marx, respectively. Market price, as measured and expressed in money, and living socially necessary labor time as the magnitude of value, do not have an exact quantitative coincidence. Just like the calendar – which took thousands of years to establish – that measures the earth's orbit around the sun is not exact but must be adjusted every four years to account for the lack of determinism in Nature (Pannekoek 1961, pt. 1). Likewise, the deviation of the position of a spacecraft sent on an intragalactic mission from the position as predicted by Newton's equations is illustrative of the same lack of certainty in the universe (Thunderbolts 2009). This falsifies Mill. Nature is everywhere both necessary and contingent, meaning that the natural sciences are not exact as Positivism asserts. Even if price and value did coincide it would only be temporary and an immediate deviation would ensue (Marx 1857, 137). However, this does not make it an unknowable mystery since we can understand it when we conceptualize value as a qualitative social relation of production constituted by an exchange of money capital with living labor power in the sphere of production – not an exchange of money between a financial innovator and trader/financial investor in the sphere of the cave of circulation. As in all sciences necessity expresses itself through contingency: "… *contingency* is rather absolute necessity" (Hegel 1812, 1230). In political economy this is the basis for the speculation that has always existed with respect to commodity capital (goods) but has only reached its most extreme form in contemporary global and financial capitalism.

Thus, unveiling the mysteries we can determine from substantial causality that M (1) has as its source the consumption of the use-value of the commodity labor power (production) that is the source of the wealth of nations (Smith 1776). This is what Smith, Ricardo, Marx and myself have adhered to as a basic principle: wealth is in the form of material use-value. The magnitude at which the goods exchange with money – M (2) – is determined by the socially necessary living labor time that is required to produce them. Commodities are produced when labor power is consumed along with the consumption of the tools used by workers in production.

As we've seen the creative force is labor power, which is a use-value as are the tools required for production (machinery, buildings, equipment and raw materials) – these are the constituents of productive capital or what Smith called productive labor. Productive capital is not in the market and is therefore a use-value: exchange value is not an attribute of its material substance or use-value. Thus, M (2) is value creation or operating income/surplus value (O'Neil 2007): a qualitative social relation between labor power and money capital that is not directly perceptible to the senses. This is not the social relation that characterizes the creation and exchange of securities, as stated above, since their creation entails a cost – foregone investment in productive capital – that is not part of the cost price of the components of productive capital; this means they are not consumed as objects of utility in the process of material production. Likewise, consumers do not consume them; thus, neither securities nor exotics nor derivatives are socially necessary use values produced by socially necessary labor power. Therefore, securities do not have a value but they can, potentially, have a price. These nuances explain why it can seem to be so complex and mysterious. Implicitly, then, we've seen that it's productive capital that underlies the price of securities; as is seen below it's the return on investment (ROI or the general rate of profit) from productive capital that enables the realization of the required returns on securities. Furthermore, we have confirmed the correctness of the RA's intuitions I6 – I8; as well as having clarified M (1), M (2) and tentatively, M (4).

Regarding M (3) we have seen that price or exchange value already exists in the minds of consumers/firms before they go to the market; moreover, our RA observes price impressions that are already in the market. Thus the commodities already have a price when they enter the market since they were created by labor power as both use and exchange values. As I have discussed previously, in a financial crisis – whose cause lies in the underlying movement of profitability on productive capital – in the minds of bankers, economists and traders the Fed or ECB are needed to create money and liquidity in order to offset the crisis. Implicitly this is tantamount to them thinking, at least unconsciously, that the central banks are creating value (O'Neil 2005). However, though this seems to be true to the senses, essentially it isn't since goods are already values and neither banks, nor economists nor traders produce goods. Actually it's the reverse: it's value creation, through real investment in productive capital that throws commodity capital (goods) into the sphere of circulation (the market), which leads to money creation. There are some economists that recognize this by saying that money is endogenous. Money as a means of circulating goods can be hoarded or de-hoarded depending on the needs of trade which are determined by the social relation of value creation. Thus,

money as the value-form – or as the universal equivalent of every particular form of commodity capital of those circulating commodities – is just an expression of this social relation. The central bank can't create this social relation; however, it can destroy it – via inflation – due to the misconception that it can create money when it is actually only creating debt. Likewise, neither can the government, via fiscal expenditure, create this social relation: but it can destroy it via the debt creation that ostensibly seeks to preserve the social relation (e.g., the "bailouts"). Thus, the mystery of M (3) is clarified.

The derivatives are created – "financial innovation" of debt contracts – out of the imaginations or mental labor of the mathematicians, economists, traders and statisticians operating within the cave of circulation. The creation is via imaginary models of price formation (e.g., Black-Scholes option pricing model; no-arbitrage pricing of futures). As I have already said they are forms of debt because like all forms of debt they create a future claim on the economic profit – the net operating income or surplus value that is a consequence of value creation – arising from productive capital (O'Neil 2007). Since debt forms are written in units of imaginary money or money of account, and money measures the magnitude of value as a social relation, then debt is likewise a social relation between creditor and debtor. The contracts are settled – "cash settlement" – via using money as a means of payment: hence, a supply of such cash or liquidity must be available. If it can't be provided "naturally" by a rising ROI, then it must be artificially created – "out of nothing" – via further debt creation by the "lender of last resort" or government. As Ricardo taught us, there are some things that cannot be reproduced by material or socially useful human labor or whose use can be monopolized to the exclusion of others (Ricardo 1817). These instances do not have a value but can have a price: the art of deceased artists, conscience, honor, land, political office or a slave are some examples (Marx 1867¸ vol.1, chp.3). Unlike in the case of commodity capital (goods) where price in money form expresses value, in these instances price ceases to express value and is purely imaginary or contingent having no necessary ground in social being. We have seen that the price of commodity capital already exists in the minds of the consumers/firms before the goods themselves actually enter into the sphere of circulation; it is because the goods are transformed human labor power that price can be realized by these agents when the goods are sold and this realization allows them to biologically and socially reproduce their own activity. For those who invest in these components of commodity capital – wholesale merchants – they can use money to buy and sell these goods since they can purchase them at a price below their price of production as it appears in the market and sell them at their price of production: or goods merchants buy low and

sell high. In both the purchase and the sale there is an exchange of money having the same exchange value as that of the goods that have been purchased and sold. The gain to the merchant is then part of the value that is created by the productive capital that produced those goods. As with all individual units of capital (firms) the realization of the price of their product is not a realization of the value created in their individual enterprise because the general rate of profit is formed on all units of capital and the amount of value created by all units is distributed via competition in proportion to the amount of money capital advanced. This transforms the value created by firms into the money prices of production and demonstrates that value never appears in the market; because each firm doesn't realize the value they create there is a transfer of value between firms according to the relative percentage of money capital invested in living labor power. In the case of securities or derivatives that only have an imaginary price that ceases to express value the potential gain from investing in them likewise arises from an exchange – constituting a change of form – of an equivalent amount of money for a financial asset having an imaginary price that is measured in the same number of units of money. The imaginary contract price is the average guess (expectation) of the market as a whole (e.g., the option or futures price); it is not a price of production – not necessary only contingent – but a consequence of a mental arbitrage pricing assumption that markets work perfectly or that deviations from such perfection is slight enough so as to justify an assumption that markets in practice function "as if" they were perfect (Marx 1894, chp. 9) (Kolb 2007, chp. 3). The potential gain arises from buying at a low price and selling at a higher realized market price and/or via short selling high and buying low. In derivative trading the gain only arises because one side of the contract has speculated correctly such that their expectation of the future market price movement are at least partially realized because their guess of the deviation from the imaginary price written in the contract is correct. However, the other side fails in such a realization and as a consequence must transfer actual units of money to the successful speculator as a cost of unsuccessful speculation. Money – as potential productive or commodity capital – has a value but the securities do not: in a crisis this is demonstrated via the inconvertibility of securities into money or the failure to realize their imaginary price or value. Thus, the derivative securities have the use- value of transferring an existing amount of exchange value in money form between agents in the contract whereby one side loses what the other gains and there is no value created. As I have previously said, hedging is just a form of speculation. The side that gains realizes a financial profit that is not an economic profit arising from value creation; constituting a deduction from economic profit or surplus value because while securities can potentially be transformed into money capital – and money capital can be transformed into productive capital – they

cannot be transformed into productive capital. Or, as stated above, the money invested in securities is not money invested in productive capital. There is no violation of the law of the exchange of equivalents and any utility attached to using money – to the successful speculator – via such speculation would be offset by the disutility of the unsuccessful speculator. Contemporaneously, via the bailouts of the financial industry the government plays the role of realizing financial profit because the market cannot effect such a realization. The cost is further debt creation: demonstrating that what was considered to be "financial innovation" was just a sophisticated form of debt creation. Governments can produce use-value but not exchange value. Aristotle had noted the use of money to realize exchange value, having had an intuition that it was unnatural. Just like with our RA intuitions can be quite insightful – even though Mr. Stuart Mill didn't think so. Thus intuitions I1 and I4 are confirmed and mysteries M (4) and M (5) are clarified.

The financial models falsely assume the pre-established harmony since all traders and the market are assumed to simultaneously realize an identical expected future price movement or that all have perfect foresight or a rational expectation that only deviates insignificantly from such perfect foresight (Kolb 2007, chp. 3). However, in practice this is impossible since the basis for the contract is differential expectations of the deviation from the contract price so that for hedgers of preexisting positions in productive capital it would have been better not to have hedged – when there is no loss on the spot position in productive capital – since the cost is foregone productive investment: the hedge was an incorrect speculation. The models assume markets are "normal" so that spot prices rise and that therefore there is always a buyer for distressed sales to meet margin or cash settlement requirements such that the buyer can expect to resell at a higher price. The models assume no qualitative change or crisis but practice proves that prices of the underlying commodities go down too because these prices are governed by socially necessary labor time and ROI.

III. C. Scientific Proof in Political Economy

The long and difficult climb out of the darkness of the cave of circulation has been facilitated via the guidance of the same light that steered Adam Smith in his foundation of classical political economy: the first principle that general, living labor is the cause of the wealth of nations and of the "natural price" of commodities (value creation). Adherence to the second principle of laissez-faire would assure that the invisible hand (the unobservable general rate of profit or return on investment: ROI) would lead to the maximization of the ratio of productive labor (productive capital) to unproductive labor via real investment in the "stock" (real assets) of the nation; not investment in circulation (of goods or financial assets) where only

equivalents are exchanged (Smith 1776, Books II/III). Economics is unable or unwilling to make such a distinction and consequently violates Smith's hierarchies of capital allocation via favoring financial investment over real investment. Ricardo was not only a theoretician but also a practitioner who struggled – via his parliamentary activity – to maintain fealty to both principles in order to offset a declining ROI (Hollander 1910) and develop material production (Marx 1863). His efforts were aborted due to his tragic premature death, but the unity of his theory and practice belies the position of economic methodologists – as cited by Hausman – that the principles of Classical Political Economy were not empirically verifiable. Social practice includes the sensory experience of the individual mental laborer but cannot limit itself to such particularity because it, more generally, can conceive the world via the recognition of the species' social activity of interaction with Nature as constituted by the production of wealth. Political practice arises out of this same interaction and can be either progressive or enlightened, as Smith and Ricardo thought, or it can be the opposite and act to inhibit the development of social wealth. Ricardo's professed disciples reinforced his formal logical weakness and this led to both principles being overturned by John Stuart Mill. Mill said the theory of value was "complete": no scientific theory is ever complete (Mill 1848, bk. 3 chp. 1, sec. 1). All theory must be tested via social practice. Experiment in natural science is only one such form of practice. Controlled experiment isn't possible in society, as Mill correctly said, but the other two forms of social practice – material production and politics – remain. Mill must also be given credit for recognizing the existence of natural laws in spite of his notion that they are different than social laws. However, via his substitution effect (as cited above) he most nefariously contributed to removing the political from Political Economy and the social cause of value and wealth from economics. As such, he was "removed from scientific reality" (Aguirre 1960). Consequently, Mill was the real founder of the neoclassical school rather than Jevons, Walras or Menger. The prevalent view is that Mill was part of the Classical School; but while this may be factual in the sense that James Mill and Ricardo mentored him, it is also true that the new already exists in the old. Mill's distinction between the laws of production and those of society is the embryo for the neoclassical distinction between the real and financial economies or Main Street and Wall Street. In theory this is constituted by the classical dichotomy that continues to plague neoclassical economics (Patinkin 1965) (O'Neil 2005). In practice it's demonstrated via vacillation regarding whether or not government caused the crisis of Debt Culture and the eagerness of economists to violate the principle of laissez-faire. The government does not exist separately from the "real economy" (productive capital) – nor do the finance industry and the goods market (circulation). Government can only respond to the crisis of profitability existing in

productive capital via transferring the value produced by productive labor in order to bailout the unproductive (of value) financial sector. Government only operates within the cave of circulation, to do what the market by itself cannot do, and must ultimately tax productive labor to finance its excessive creation of both money and debt to finance the bailout – after all, money as a claim on goods is just a form of government debt. Thus, social practice demonstrates the first principle: government must tax the cause of value/wealth creation or labor.

The formal logical use of the first principle by Smith and Ricardo led them to misconstrue the significance of the second principle. They conflated eternal human nature with a changeable social nature. The qualitative changes that have occurred within this social nature – since the time of Ricardo and J. S. Mill – no longer permit the second principle to create any semblance of the consequence of the invisible hand as Smith conceived it: social harmony. Ricardo thought the principle would offset falling profitability, mitigate social antagonisms and lead to progressive capital accumulation (Hollander 1910) (Marx 1863). Today, however, the government, or more precisely the State must – as a necessity of reproduction of value relations – enable the realization of the imaginary prices of the "toxic assets" to offset falling profitability; this is why I call contemporary capitalism neo-mercantilism rather than neo-liberalism as the liberal economists and commentators have labeled it. This necessity is the phenomenal form of appearance of the falling rate of profit that Positivists maintain is not a falsifiable hypothesis. However, in today's conditions who can deny the collapse of profitability! The State can intervene only within the mercantile sphere where equivalents are exchanged; it cannot do so within productive capital because it would then cease to be capitalism. Hence, the financial markets fear the nationalization of interest-bearing capital (the banks). Thus, both conservatives and liberals lament that contemporary capitalism is a form of socialism. To the conservatives Obama is intruding into the realm of free enterprise and disturbing the pre-established harmony of the market economy. To the liberals Obama is unfairly socializing the losses of the financial industry by the bailout. This latter group thinks that capitalism can go back and re-establish its Golden Age and restore a gentler form of State intervention that can ameliorate the untidy shortcomings of neo-mercantile activity. The conservatives have faith that the bailouts will initiate another bubble because "…a thoroughgoing effort to tame finance would be futile...finance is a remarkable creation. Do not suppress it, but use it wisely…" (The Economist 2009).

While Smith had a more profound historical grasp of the social nature of wealth and value creation, Ricardo, James Mill and J. S. Mill used nonhistorical, formal, sensory experience to deduce that the tools of production are immediately, or in

themselves, capital (Ricardo 1817), (Mill 1821), (Mill 1848). The contradictions arising thereby in their thought processes led to the notion that there is a price or value inherent to these tools such that it is an attribute of their material substance. It's the source for the neoclassical notion that use-value causes exchange value – even though Jevons maintained that utility is not an inherent property of goods (Ekelund 1983, 314). For Jevons utility is a puzzling, unobservable, secondary quality – existing only in the mind of the individual – that causes exchange value. Thus, implicitly, even for Jevons the nonhuman components of productive capital – the tools of the species – cannot have a price or value in the sense that price or value are attributes of the corporeal substance or content of these tools, i.e., what they are made of in terms their natural properties. The identity between Ricardo, the Mills, Jevons and all economists mentioned in this text, however, is that exchange value is an attribute of an eternal, universal human nature; but human nature is social nature at a particular period of a history that is not eternal but constantly changing: thus human nature is also changing and not eternal. From the first tools, fabricated by early hominids out of flint, to the silicon of electronic tools, there is nothing that is a constituent component of these transformed natural substances that one can observe as being a price or an exchange value. As the qualitative content of the tools changed – via production from the Stone Age to the Electronic age – so did the social and human nature of their creators. Yet all living economists insist that these tools have such a price or value. Both components of productive capital, the tools – or real assets – and labor power are use-values. The latter is the efficient cause – to use Aristotle's term – of value creation. I myself in O'Neil (O'Neil 2005) incorrectly referred to the value of productive capital or real assets. Since value is not an observable quality of their material substance or corporeal form – their physical shape as transformed natural objects – it can not appear as a quantifiable magnitude in the market (empirically) either because all that appears quantitatively must have a qualitative essence that underlies it. Thus, the common refrain that "we can't find value" in the market becomes explicable. Quantity and Quality, as categories of Nature, are a unity that cannot be understood separately. Even the abstract formal equations of mathematicians must have an underlying essence in natural processes if they are to remain a rational description of these natural processes. This is the point made by the plasma cosmologists in their critique of mainstream cosmology. Likewise, the equations that the economists use to demonstrate the eternal being of capitalism lack the same qualitative content on both sides. The left-hand side – in firm valuation – is in the form of real assets (tools or use values) while the right-hand side is in financial asset form (money or exchange value) (O'Neil 2007). Just like in all sciences it's the qualitative aspect of Nature that the scientists find difficult to understand.

The article by *the Economist* was presumably referring to the shadows in Plato's cave – which do not reveal the essential nature of their source or cause – when they were discussing the mathematical equations used to determine derivative pricing. They themselves confirm my points regarding value as an essential, unobservable, qualitative social relation, when they say "…share-price movements are violent… There is a constant danger that behavior in the market changes, as it did after the 1987 crash, or that liquidity suddenly dries up, as it has done in this crisis. But the quants are usually pragmatic enough to cope. They are not seeking truth or elegance, just a way of capturing the behavior of a market and of linking an unobservable or illiquid price to prices in traded markets…" (The Economist 2009). As noted above, the actual traded or market price must prove in practice to deviate from the unobservable imaginary price as calculated by the model. The "quants" then may not seek truth but their practice will nonetheless reveal it even though they and the contract agents are unaware of it since they are not interested in what exists outside the cave of circulation. The constant danger is the qualitative change – "tail risk" – arising from changing underlying conditions of social value relations – the tendency for profitability on productive capital (return on investment or ROI) to fall – that neither mathematics nor economic models can address because it cannot be translated into a quantifiable variable in the equations. Nonetheless, the financial markets attempt to quantify in units of money (price) a qualitative aspect of social nature (value), which is not a component part of the productive use-values themselves. Such equations lack an essential ground in social nature just like the equations of Big Bang cosmology lack an essential ground in non-social Nature (Thornhill, 2009a). In both sciences the consequence is that it makes it "impossible to relate cause and effect" (Thornhill 2009b).

Financial valuation models – used by practitioners to advice investors or financial asset speculators – treat the profitability on productive capital (ROI) as an exogenous variable that is therefore considered to be purely unpredictable or contingent – or a disturbing cause in Mill's language. We've seen that Ricardo warned James Mill about substituting the contingent for the necessary component. Yet necessity or scientific law asserts itself via such contingency. In this sense scientific law is necessary contingency (or contingent necessity): as discussed above the law of value operates in this way just as scientific law operates in the rest of Nature (Gollobin 1986, chp.16) (Engels 1888). The confusion of scientists and intellectual workers enters when they look only at one of these two sides (e.g., quantum physics). Thus, there is no dichotomy between the laws of production and social nature as Mill thought. In corporate valuation, value creation is defined as ROI > cost of capital (COK) which is considered to be equal (in equilibrium) to the returns expected

(and required) by the investors (speculators) in the financial markets who are then said to use these expected or required returns to discount cash flows arising from a presumed given real investment in productive capital: all of which is considered to subjectively manifest itself in financial market prices. These prices are merely imaginary guesses or speculations upon something that cannot be quantified at all because the speculators in the financial markets falsely identify the financial assets with the real assets whose consumption by the human component of productive capital results in value creation. Thus "price or value" of the real assets exists only in the minds of the speculators (investors) and the theoreticians of such speculation. They are speculators because only the units of productive capital – capitalist enterprises – can invest in the real assets. This investment is both cause and consequence of the ROI or rate of profit that is actually determined by the accumulation of productive capital (the activity of the totality of firms expressed as systematic risk). The models of financial engineering, created inside the cave of circulation, along with corporate finance theory, advised practitioners that they could use debt to lever up the required returns ignoring their own capital budgeting theory that shows that for these returns to increase ROI must increase as well – otherwise value creation decreases. Thus, even within neoclassical theory it can be seen that such engineering – as stated above – has a cost of foregone productive investment since investment in securities does not form a component part of investment in productive capital. Like interest it can only be a deduction from the operating income or surplus value of units of productive capital (non-financial firms). The theory and practice of corporate finance are inconsistent since capital structure theory – teaching that debt creates value – likewise ignores the necessity that the leverage effect can only be positive as long as ROI increases sufficiently to pay interest. Securitization ignored this because it's seen as exogenous (O'Neil 2007). Otherwise de-leveraging must occur – as it is now with a most retributive vengeance. Thus, ROI is purely contingent in these theories because since Mill's time productive capital has been substituted out of investors' portfolios. Therefore, in economic theory there is no necessary contingency – and therefore no science – yet the operation of the qualitative change now manifest in the social nature of value relations has necessarily asserted itself, demonstrating that social practice is the source of scientific confirmation in political economy. Consequently, the necessity of deleveraging confirms in social practice the falling rate of profit arising from value as a qualitative social relation of production.

As O'Neil (O'Neil 2007) showed, the problem is that such enterprise sees such real investment as a burden to be overcome via using leverage or the capital of others (debt) to invest (speculate) in financial assets. This is what I called the

Proclivity. The ideal mental existence of such "price or value" regarding the inorganic components of productive capital reflects the misconception – or false principle – of the eternal nature of capitalism as the only possible form of economy consistent with human nature. The financial engineers thought they could use formal mathematical logic to create imaginary value forms out of nothing that would enable them to bypass investment in the forms of productive capital – thereby violating Smith's hierarchies of capital allocation. It appeared to work as long as the unobservable ROI and debt creation enabled liquidation and re-formation of financial mercantile trading positions. This is just the contemporary form of the same formal logic that led to the disintegration of Ricardo's political economy and the inability to maintain adherence to the second principle of laissez-faire by J. S. Mill (Pilling 1972). When the appearances don't conform to the premises the power of the State can then be used to enforce the premises since as the *Economist* noted above "well connected people …get their way". If the "toxic assets" do not have a price, because the human nature of the financiers who made them makes mistakes then "everyone else has to pay for them" via legal mandate. Therefore, it wasn't an April fool's joke when Maria Bartiromo said "all agree that the price of the toxic assets will be marked up" (Bartiromo 2009); because on April 2 the Financial Accounting Standards Board mandated that markets aren't pricing assets fairly – that is according to the imaginary fair value as determined by mathematical or arbitrage pricing models. This "…will make it easier for companies, including banks, to value assets using their own internal models rather than market prices. They will…only have to recognize a part of any impairment in their profits" (Guerrera 2009). Banks can then set their own imaginary prices – "marking-to-model" – in order to offset the collapse of profitability and restore the flow of credit or Debt Culture. Consequently, the principle of mark-to-market that was claimed in theory to underlie the rationale of Securitization, can now, in practice, be violated. Again, practice falsifies the theory of economics. According to the logic of Mr. Greenspan human nature imposes, via "irrational exuberance", an unfortunate Millian disturbing circumstance that "we cannot learn". Since this is considered to be "the truth", according to the Economist, the consequence is that the limbo regarding ownership of productive capital (O'Neil 2007) – arising from the imaginary option pricing model known as Black-Scholes – has now likewise migrated to ownership of the principal form of interest-bearing capital: the banks. Thus, another puzzle of formal logic appears: to nationalize or not to nationalize the banks. The vacillation arising from this puzzle thus leaves "Capitalism at Bay" (The Economist 2008).

Conclusion

When Hausman asked – what are economic models? – he was showing a keen intuition that they only explain an imaginary theoretical world that that has no ground or substantial causality in economic practice but only can be mandated via the political practice of bail-outs and marking-to-model. This is because the extreme division of labor in which they are created separates itself in theory and practice from the substantial causality of value as a social relation of production. This is a socially imposed disconnection that produces the false appearance that human beings are incapable of distinguishing between words and deeds. However, the intuition that provided the light to exit Plato's Cave suggests that we can learn and use human reason, like Adam Smith did, to clarify the complexities of the Monetary system that is imposed upon us by social nature. Perhaps Greenspan and the prevailing consensus vacillation regarding the causal nature of Debt Culture only represents the opinion of those who have removed themselves from Nature via substituting productive capital out of their portfolios. The failure of financial creation out of nothing is a failure to acknowledge form in Nature. However, as the Greeks showed us, science must do this: the species survived because it could recognize form in Nature. The vast majority of those who are in closer contact with Nature are only just beginning to learn and to use their intuition to draw some necessary conclusions that will enable them to find the light that can illuminate and rationalize their own social nature. After all, history demonstrates that the species learned from Nature and used this knowledge to change their own social nature so that they wouldn't have to confine their existence to cave dwelling.

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Developments in Human Resource Management Practice in Estonia

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The first evidence of personnel management emerged in companies in developed industrialized countries at the end of the second industrial revolution, i.e. at the beginning of the 20th century. Personnel management has been gone through several stages of development even as society and economy have evolved. Certain stages could also be identified in the development of personnel management in Estonian companies after the Second World War, in a country which was incorporated into the Soviet Union and regained its independence in 1991. In the Soviet Union, during the period of 1940–1991, normal development processes in many fields, including people management, acquired features typical of that era.

The period in personnel management that lasted until the end of the 1950s can be called administrative-ideological (Svetlik et al., 2007). Enterprises were large, overstaffed, and inefficient. Effective use of human resources was not the aim. The aim was to provide everyone with jobs. People management was greatly influenced by political-ideological factors.

The period of political "thaw" and the attempts to reform the socialist economy in the Soviet Union brought about new ideas in managing organisations and people. In the 1960s and '70s, Estonia started to gain access to information on the trends in that field in market economies around the world. An important role was played by the so called Finnish window phenomenon which manifested itself in direct contacts between Estonian and Finnish management consultants and researchers. This period also witnessed the beginning of academic research into management issues, particularly in Tallinn University of Technology. In some industries (textile industry, rural construction) development programmes for managers and specialists were created and carried out. The positions – "deputy general directors for dealing with personnel and social development" – were created in some large production companies (ibid.).

The end of the 1980s marked the introduction of significant changes in the personnel function in Estonian organisations due to institutional changes and movement

towards a market economy. Organisations as well as peoples' attitudes changed, personnel management faced new tasks, and new approaches and methods were implemented. As a result of these changes, the development of the personnel function in Estonian organisations reached the stage of the rise of professional personnel management at the beginning of the '90s. Its characteristics and evolution into human resource management are dealt with in this article.

Personnel management in Estonian organisations since 1991

With the restoration of independence and the appearance of a market economy, changes also appeared in the personnel function. Economic decentralisation and privatisation quickly led to economic restructuring and changes on the labour market.

Various and extensive direct foreign investment and the opening up of foreign markets provided a basis for rapid economic and technological development.
At the beginning of the 1990s, new labour legislation was adopted to govern relationships between employers and employees at the individual and collective levels under the new conditions of the market economy. The majority of the essential acts of law regulating labour relations were worked out and adopted over a ten-year period. One of the most essential acts of law in the labour law package is the Employment Contracts Act adopted in 1992.

Labour relations had been characterised by weak trade unions, which had no influence whatsoever over the arrangement of labour relations. Compared to the Soviet period, membership in trade unions has decreased dramatically. The union density rate is approximately 15% (Eamets & Masso, 2004). According to a survey conducted by the International Network of Strategic Human Resource Management, CRANET, carried out in 27 countries, Estonia ranked last among other European countries according to the number of people involved in trade unions: in two thirds of the Estonian companies studied, there were no trade union members at all (Alas, 2004).

All these factors accelerated the development of the personnel function. Compared with staff administration during the Soviet period, the changes in the personnel management field were enormous. The disintegration and disappearance of existing organizations destroyed old staff departments, former personnel employees were mostly discharged, and new labour laws were worked out. The majority of typical role models in business were destroyed as well (Tepp, 2007).

Following a period of rapid development of entrepreneurship and privatisation of public enterprises, Estonian companies emerged as relatively small. Due to this fact some companies did not create the position of personnel manager/specialist, and the tasks of personnel/HR management were shared between the managing director and heads of other functions. In companies with fewer than approximately 50-60 employees, the tasks of the HR manager/specialist have been delegated to a person in another position (Alas, 1998).

The culture of personnel/HR management in this period has largely been influenced by the subsidiaries of large Western enterprises in Estonia. The practices of these companies have served as an example to a number of local enterprises in developing the function of human resources. Similarly, there has been rapid development of HR managers and specialists. In Estonia, the first initiatives to interpret the new roles of HR and create an understanding of HR as a profession came from training and consultancy firms (Tepp, 2007). Besides continuous further training, professionalism has been developed by obtaining practical experience, in which foreign companies have played a great role. The services of companies providing further training in management came to the market faster and in a more flexible way than the faculties of economics at universities and business and management schools were able to offer. Since the middle of the 1990s, academic study programs have provided courses dealing with human resource management and development, and as of a little later also the corresponding specialisation options. Professional HR managers have had worthy challenges in companies with foreign ownership and these, in their turn, have facilitated a wider development of the personnel/HR function as such in the whole country (Alas, 1998).

The second half of the 1990s was rich in changes that took place in organisations. The changes were brought about both by Western capital that started to pour into Estonia and by Estonian entrepreneurs who began to invest in neighbouring countries. The reason the role of HR managers expanded lay primarily in the fact that implementing organisational changes required the preparation of employees. Some prerequisites for successful changes include communicating, informing, motivating and involving the employees. Considering their preparation and responsibilities, personnel/HR managers in several large organisations were the most obvious people to handle the abovementioned tasks and to advise other managers. However, this was by far not the typical characteristic of HR management in all organisations in Estonia. Such a function primarily existed in larger organisations that employed competent HR managers, also recognised by top executives.

However, in the middle of the 1990s, there were but a few organisations in Estonia that viewed HR managers as strategic partners to senior managers. Similarly, there were not many companies with senior managers who would have accepted HR managers as business partners. It has to be noted that HR management was not one of the highest priorities among the many fields that required development (Alas, 2001).

One of the researches of the last decade arrives at the conclusion that personnel/HR managers, as a rule, do not act as strategic partners to senior managers; and senior managers, in their turn, are not quite able to put their finger on those objectives where the expertise of HR managers could prove invaluable (Kalda, 2001).

The situation of personnel management of the 1990s in Estonia has been presented in research data in the Cranet survey. Based on the data from the 1999/2000 survey, Ignjatovič and Svetlik (2003) have carried out an analysis that divides the European countries that participated in the research into four clusters. The organisations that belong to the countries of the Western cluster enjoy a stable environment and represent a professional model in HRM. The characteristic feature of the Northern cluster is the model of employee-centred HR management. The Central- and South-European cluster is characterised by an approach that supports the management. The peripheral cluster includes countries where companies operate in a mostly dynamic environment and the management-centred model dominates. Based on the research carried out at the end of the last decade, personnel management in Estonia has found its place in the peripheral cluster.

From personnel management towards human resource management

In Estonia a shift from personnel management to human resource management most likely started at the turn of the century. The Estonian economy was on the increase; new institutions had been established and adapted to the requirements of the European Union.

The results of the second Cranet survey carried out in Estonia in 2004 showed that the field of human resource management witnessed a growth trend in its strategic nature (Estonian Cranet Report, 2004). The role of line managers within human resource management was growing. Companies invested greatly in training employees according to the needs of the business and in carefully selecting, recruiting, and motivating managers and specialists.

Personnel/HR function

Data from the research indicates that the number of people employed in HR departments on average was a little less than one per 100 employees. This number is extremely low compared to the European context, where the number of employees in HR functions per 100 workers is 2,52 (Svetlik, 2006).

The beginning of the current decade in HR management is characterised by the active development of HR strategies and policy to support overall business strategies. The development of HR policies is carried out not only by specialists in this field – other employees in the organisation have also been included in this process (Alas, 2005).

Organisations and HR managers started to develop HR policies and strategies in order to support their strategic objectives. The number of organisations where mission statements and strategies are defined and formulated in writing has increased (Table 1). A notable shift has occurred in the definition of HR strategies, which testifies to the aspiration of organisations to integrate HR strategies into corporate strategies.

Table 1 Percentage of organisations with written strategies and mission statements

	2000	2004
Written corporate strategy	62%	67%
Written HR strategy	26%	47%
Written mission statement	62%	72%

On average, in the business sector every second organization had a written HR strategy in 2004 (Fig. 1).

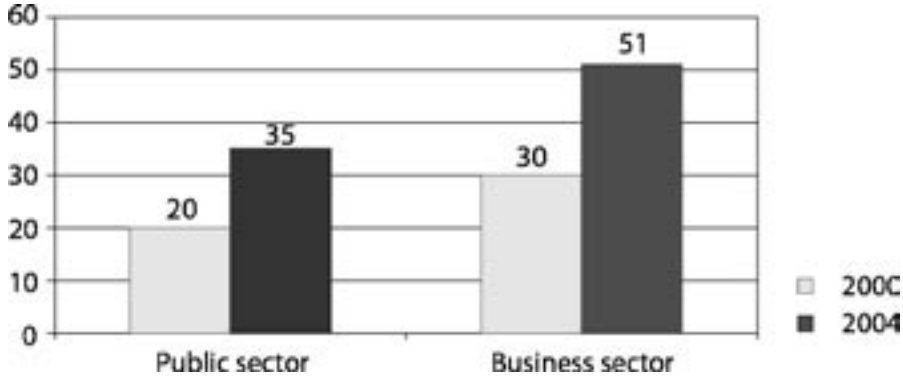


Figure 1 Existence of written HR strategies in business and public sector organisations (% of organisations)

This change is probably prompted by the business needs of organisations, which motivate the HRM function to design activities in the interests of the efficient implementation of corporate strategies.

Another characteristic is the movement of HR managers into the sphere of company management, thereby participating in and contributing to discussions. A slight shift has occurred in the involvement of HR managers on the management board of organisations (Fig. 2). The involvement of a personnel manager in the management of a company signals the recognition of him/her as a business partner and adviser to top managers.

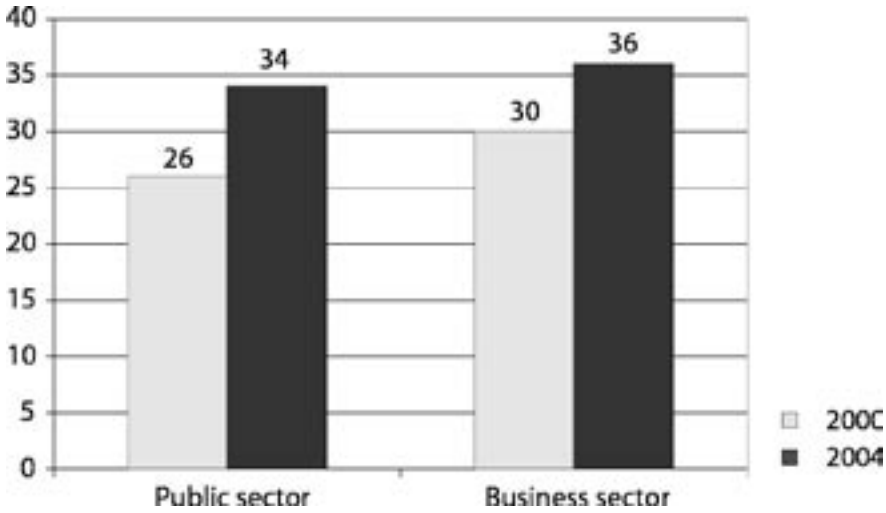


Figure 2. Involvement of HR managers on the management board (% of organisations)

Survey results in 2004 demonstrate that 34% of HR managers in public sector organizations and 36% of HR managers in companies consider themselves part of the management board or the equivalent in the organization. In 2000, the involvement of HR managers in the general management of organizations was somewhat lower.

Figure 3 demonstrates that no significant change has occurred in the beginning of the new decade in the involvement of HR managers in terms of organizational strategy.

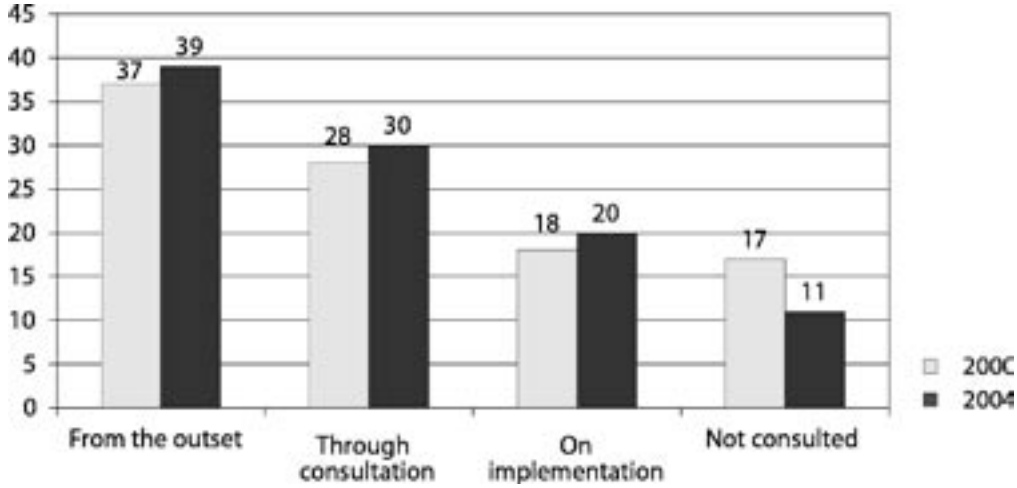


Figure 3 Involvement of HR managers in organisational strategy (% of organisations)

Nearly 40% of HR managers claim that they have been involved in organisational strategy issues from the outset.

The role of line managers in the HR decision-making process indicates the growth in this tendency. Rather than HR managers, the ones who implement HR strategies tend to be line managers. The survey also studied the distribution of responsibility in making HR policy decisions. The results demonstrate where responsibility for different HRM aspects lies with line managers, where it lies with HR managers, and where they share the responsibilities (Table 2).

Table 2 Main responsibility in making HR policy decisions in Estonian organisations with 200 or more employees (% of organisations, 2004)

Area of responsibility	Line managers	Line managers and HR department	HR department and line managers	HR depart-ment
Recruitment	7	47	42	4
Pay and benefits	27	47	22	4
Training and development	2	35	56	7
Labor relations	11	37	39	13
Workforce expansion or reduction	29	56	13	2

Data presented in Table 2 involves organisations with 200 or more employees for the reason that these organisations can be expected to have a HR department.

Matters of pay and workforce expansion/reduction are issues where line managers have the first say and clearly carry the main responsibility. In principle, the distribution pattern of decision-making and responsibility between line managers and the HR function has changed little since 2000.

To sum up, one may say that in both the private and public sector, the number of HR managers that have been included in the management of the organisation has slightly increased, but there is no significant change in the HR managers being included in the process of strategy development. There is, however, a considerable step forward in formulating strategies, which is especially predominant in the growing number of organisations with a developed HR strategy. The position of HR managers in terms of business partnership has improved compared to the situation at the end of the 1990s. HR functions are more than ever being filled by outsourcing, which sets limits on the growth in the number of people working in the HR department.

The essence and level of HR management is more or less similar in the private and public sector – the organisations in the public sector have caught up with the practices pursued by the private sector. Essential differences in the levels of HR management are larger between small and large enterprises rather than and between public and private organisations.

Recruitment & Selection

The search for employees, their selection and recruitment, has become an increasingly more essential and complex task for organisations. As a rule, in a country with a developing economy the demand for highly qualified specialists to satisfy the needs of the labour market is greater than the supply. It is typical in Estonia, as well as in the rest of Europe, that organisations face difficulties in recruitment and retention of competent employees, especially professionals. There is a wide gap between the demand for and supply of specialists in Estonia. Disproportions between higher education and vocational training, social sciences and technology manifest themselves to the detriment of the latter (Vanhala et al., 2006). The outflow of labour from certain sectors to countries offering better wages and salaries and the resulting rapid growth in the levels of wages and

salaries in Estonia are additional factors making recruitment more complicated. Such a situation on the labour market provides the background for recruiting and selecting employees in organisations in Estonia. This is probably the reason why HR departments in different organisations spend most of their time searching for, selecting, and recruiting employees.

Companies tend to use various sources while recruiting. The source most often used is public advertising**,** especially in circumstances where the company itself lacks employees with the necessary competency. Internal recruitment is also popular. Recruiting directly from universities or institutions providing higher education has been marginal, but in the changing circumstances this way of recruiting has become increasingly popular.

The first recruitment agencies were established at the beginning of the 1990s. These companies started to implement search- and assessment methods which were also accepted by Western companies. Therefore, most of their clients comprised foreign companies setting up subsidiaries in Estonia.

In 1996, the first internet-based recruitment agency CV-Online was established by four students in Estonia in order to assist students in obtaining jobs. Today the company has expanded into eight East and Central European countries and is the largest among Internet based recruitment companies in this region.

Since the beginning of the current decade, internet-based searching has become widespread, and the use of print media as a channel for search is a common practice. Interviews and background checks are the most preferred among selection methods. These are supplemented by methods displaying the applicants' skills and behaviour within a group. Tests on personality, abilities, and behaviour types are also frequently used. When making a selection, the element most considered is the compliance of the applicant's personal qualities with the values of the organisation (Alas, 2005). The three most frequently used selection methods include personal interview, letter of application, with a CV and references.

Relying on the description of the situation on the labour market, one of the most important issues in HR management today and in the future in Estonia is how to be attractive as an employer in order to find people suited to your business needs.

Reward and Performance Management

In the Estonian business sector there is a high level of decentralization in establishing basic wages (Table 3). Estonian businesses are characterized by a wide diversity in determining wages and a high proportion of individually established salaries.

Table 3 The level at which basic managerial and employee wages in the business sector are established (% of respondents)

	Managers		Manual employees	
	2000	2004	2000	2004
National/industry level	2	4	3	5
Regional level	2	3	2	-
Organization level	41	36	44	33
Structural unit level	14	15	30	27
Individual level	66	74	31	27

During the four years from 2000 to 2004, there have been no significant shifts in the proportions of how pay is established. National and regional levels are represented by a minimum proportion. Managers' wages have become slightly more individualized. The majority of organisations follow the practice of fixing the salaries of managers and specialists according to individual wage agreements. In larger organisations, where the development of pay policies is more advanced, company level determination of basic wages is dominant. The pay for workers is mainly fixed on three levels – individual, organisational, and according to structural unit.

In the use of remunerative incentives, profit sharing demonstrates the most distinct change tendency (Table 4).

Table 4 Use of profit sharing and share options in business organisations (% of respondents)

	Profit sharing		Share options	
	2000	2004	2000	2004
Management	19	31	7	10
Professional/technical	5	15	2	2
Office/administrative	3	10	1	2
Workers	3	5	-	2

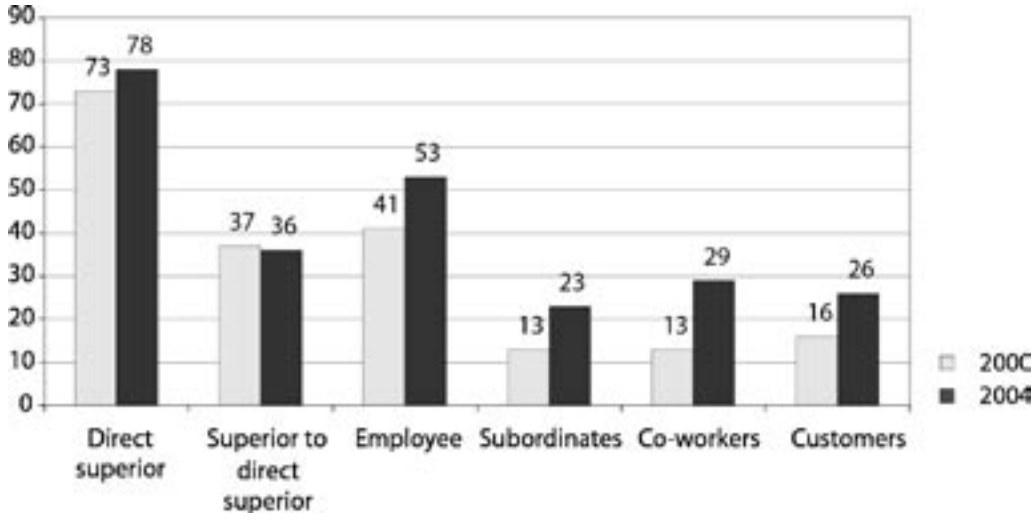
The number of companies where profit sharing was applied had grown by the year 2004. Nearly one third of businesses include the company management in the profit sharing scheme. The use of share options did not manifest any significant change, except for the managers.

If possible, companies frequently use a system of pay-for-performance. To do so, a number of companies have implemented a system of performance assessments. The system depends on company results, personal results, and a prerequisite of meeting the profit plan.

In large enterprises pay systems are frequently based on job evaluation. The most widespread tool used is the Hay system. Since the beginning of 2000, companies have seriously started to consider competency models. Performance assessments and development discussions have become frequent.

In addition to assessment by the immediate manager, the importance of other assessors has increased. Changes that have taken place in employee performance assessment by the year 2004 demonstrate that the number of organisations where the principles of 360 degree assessment are applied has increased (Fig. 4)

Figure 4 Use of different assessors in employee performance assessment (% of organisations)



On average, subordinates, co-workers and customers were involved in performance assessment in every fourth organisation. The results of performance assessment were more frequently linked to determining employee training and development needs, career planning, pay calculation and rewards. Lately, different systems have been implemented to provide assessments via the e-environment

Training and Development

Employee training is the second most time-consuming area next to recruitment and selection within the scope of the HR function (Kalda, 2001). In Estonia, employee training may be considered as the most advanced area of HR management. Due to the transition to a market economy at the beginning of the 1990s, an enormous demand for new knowledge and skills emerged. The Adult Education Act was passed in 1993, which, in addition to regulating general and informal education, also regulates the market and conditions for additional training.

The business needs of companies both in the strategic and short-term perspective have been a decisive factor when training employees. Estonian organisations tend to base their employee training on identifying training needs. While identifying and assessing these training needs, companies have resorted to competency models and development discussions. Competency requirements have been developed to unite business strategies and employee training. Therefore, it is safe to claim that the reasons for employee training rely on the development needs of companies and their employees. Training results are assessed via the results at work, and in this, clients also provide a valuable source of information (Alas, 2005).

Employers accept significant expenditure to satisfy development needs. While developing the training budget, the measures are its ratio to salary expenses and the number of training days per year. The average ratio of training costs to salary expenses in Estonian organisations is around 3.5% (Estonian Cranet Report, 2004).

As a rule, Estonian organisations offer their employees a relatively substantial number of training days each year. The average number of training days received by different employee categories has increased relatively little between the years 2000 and 2004 (Fig. 5).

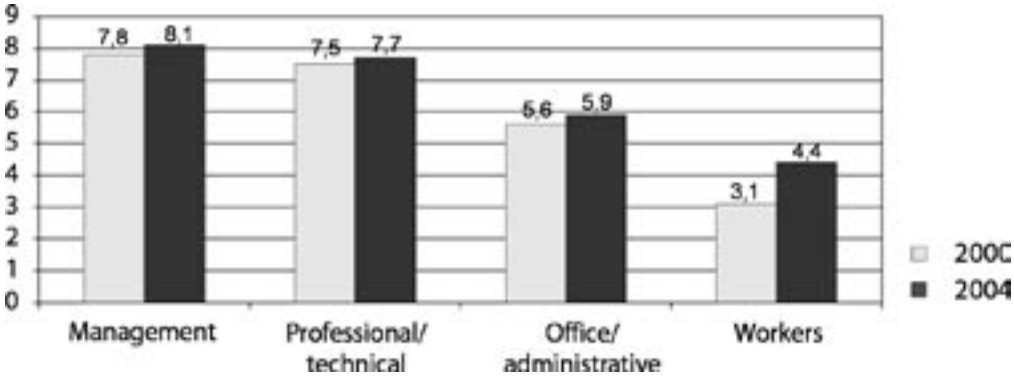


Figure 5 Average number of training days received according to employee categories

Training is considered important for all company employees. In order to train managers, specialists and teams, organisations use the help and services of training companies. Besides using training companies, in-house vocational and additional training mainly involving workers are also practised.

The latest Cranet survey showed that the most important training areas in organisations in the nearest future have been defined as the need to improve customer service skills, leadership and teamwork skills and IT literacy.

The Future of HRM

Conducting Cranet surveys in Estonia has provided the opportunity to look at the situation of Estonian HR management in the context of other European countries. Based on the cluster analysis referred to in the above chapter, Estonia belongs to the peripheral cluster along with a number of other East-European countries (Ignjatovič and Svetlik, 2003). At the same time, the "old" market economy countries form regional groups with common features, where the development of HR practices has been strongly influenced by regional and local factors. The relatively similar institutional conditions of East-European countries have most likely defined the development of fairly similar HR patterns.

In principle, the peripheral cluster should fall apart and those countries should find their place in the clusters that are closest to them geographically and culturally.

Based on the transition of HR management from the East-European cluster to that which is geographically closest, one may assume that in similar political and economic circumstances (democracy and market economy), the common features of HRM are mainly influenced by the cultural aspects of a region and by the institutional effects characteristic of the state.

In the article by Vanhala et al. (2006), the authors have pointed to an explicit convergence between HRM in Estonian and Finnish companies. Estonia is located in the same cultural area that has shaped HR management in the Nordic region. Therefore, the developments and processes inherent to Finland may also be expected in Estonia. We may probably assume that although lagging behind a number of years, Estonia is to take the same route that organisations in Finland and other Nordic countries once did. One may find similar features in the rapid development of HR management strategies, accompanied by the trend of informing employees and involving them in decision-making processes.

Nevertheless, the convergence will not be consistent in all the indicators. For instance, the totally different trade union landscape in Estonia compared to other Nordic countries will doubtlessly have a different effect and create different practices in the field of labour relations. Estonian enterprises are characterised by direct relations between the employers' representatives and the workers. Therefore, two powers – the HR management professionals and managers at different levels – will remain central. The development of Estonian HR management has been greatly influenced by the implementation of information- and communication technologies within the structure of organisations. Network- and virtual organisations along with flexible working relations and methods of working present the area of HR management with totally new challenges.

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The problems of contemporary control in postmodern society

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Society and economy have gone through rapid changes during the last 20 years. These years have brought along a lot of new things to learn and new experiences. In addition, modern societies from the 19th century to the (present) day have been characterised on the one hand by legislation based on public law, discourse and organisation, whose connecting principle is the sovereignty of the society has a whole and delegating the sovereignty of the individual to the state. On the other hand, this brings along with it tight connections between disciplinary constraints, which are not reflected in the accompanying legislation. The basis of the existence of all states is the permanent population of the state, its fixed territory, and effective state authority, therefore it is important that the state cannot act as an absolute subject, it needs people. The authorities, and the people, wish that the representatives elected by them would rule the state economically and thriftily. The modern state uses social authority inherent to organised society and a system of social superordinate and subordinate relationships, without which the collective and purposed activity of people would be impossible, thereby the role of authority becomes very important in the relationships inside the society, which are becoming more and more complex.

Michel Focault has noted that authority works between two borders – the sovereign right and the network of disciplines – and that power relations work inside the entire society. He says that if one wishes to find out how authority works, then the mechanisms of authority between two borders, where on the one hand authority is formally controlled by legislation and on the other hand statements of truth produced by the authority assure the power, should be detected (Foucault 2002, 295). In the relationship between power and legislation balance has a significant role, and this can be guaranteed through democratic institutions of control. Therefore, control and monitoring are very important to the people as the carriers of authority. Citizens and other individuals communicating with public authorities, but also the public authorities themselves, are interested in the monitoring of the public sector of the state. Individuals under consideration are citizens, foreigners, stateless persons and legal persons, who as taxpayers are interested in that the resources of the state would be used for organising relations regulated by the

legislation and for providing public services and that this would be done timely, systematically, and economically while avoiding all possible abuses in the field. Individuals are mainly interested in that they would be protected from the possible arbitrariness and injustice of the public administration (Siibak 2001, 171).

The public administration itself is also interested in the control, as authority wishes to guarantee rational, effective and normative leadership. On the one hand, the functioning of the public administration required stable legislative security for carrying out administrative operations, as through controlling administration information about the legality and expediency and the factual and real effects of the activities of the executive power, while on the other hand the interests of the executive power are connected with the ruling authority while keeping in mind its citizens and public opinion to ensure the trust of the people and the longevity of the political rule.

The aim of this paper is to find a solution to two main issues, which have risen along with the changes in society. Firstly, as **a result of the constant changing of society a need to modernise the working principles of economic control has developed**. The principles which existed in the industrial society cannot be used in the contemporary post-modern society as this society is characterised by constant development and in the modern world, characterised by focussing on information technology, old principles are being substituted with new rules of the game[1]. Still, there is no need to create a wholly new system of economic control, as the efficiency survey of The National Audit Office of Estonia [2] has shown, **the deficiencies caused by the work of The National Audit Office are connected with constrained outputs caused by the legislation**. Therefore, the control-functions in their modern sense will remain in effect, but as a result of the post-modern treatment of society opportunities should be sought to make the existing system of control more efficient.

In a society where the economical, social and political circumstances surrounding us are rapidly changing it is understandable, that the society needs an efficient and viable system of control, which would react to these changes consciously. All the phenomenon and insitutions of modern society should be viewed from the

[1] A.J.Bozo de Carmona. Toward a Post-modern Theory of Law. Online. Available http://www.bu.edu/wcp/Papers/Law/LawBozo.htm, 30.03.07.

[2] Eksperdiuurimus Eesti Vabariigi Riigikontrollis 1999 ja 2005. Arvutivõrk. Kättesaadav www.riigikontroll.ee, 12.11.07.

point of view of the changing society, and the current system of control should be viewed from the same perspective. In addition the historical issues regarding control should be taken into account. When compared to the modern approach to society there have been many different changes in the contemporary society, which have resulted in changes in the content and methodology of executing control. For example, when looking into the future it is obvious that in society two questions become important: how to prevent control free space and whether it is possible to control everything in society.

The growing importance of information and the development of information technology have affected the field of control and its methods. Nowadays information has become an exchange value or an article of merchandise and the development of information technology has become a powerful paradigm which affects the development of the world and which has overshadowed all the global issues of the 20th century. The purpose of information technology should be to harmoniously employ it for the good of all societies in the world. For example using information technology in education is a natural development of society and a remarkable accomplishment of science. But, unfortunately, history has shown that new accomplishments are often followed by dangers that are hard to predict and which become seen only when they have caused unforeseen damage. For example, the criminal cyber attacks suffered by Estonian public institutions in the first half of 2007, which have been discussed lately is an example of the negative influence. Unfortunately, experts have assured that these attacks are easy to organise and that the possible victims can be also the national control and monitoring authorities.

In this situation the decisive aspect is that in the case of a criminal attack the development of the problem should be foreseen, however for that to happen it is necessary to know how to use existing information. Therefore, it is necessary to find connections between events that are taking place and this would be easier when there is a certain and acceptable format of finding them.

As using information technology for criminal purposes could bring significant economical loss to the state, and is becoming an important issue, as well as the development of the new situation of society new issues are developing which require solving by the society as a whole and also from the perspective of control institutions. The transition to an information society has created many fields which require controlling, which did not exist in the industrial society and these fields have

to be controlled by the controlling authorities, because the goal is to make sure that the new outputs of the information society are used rationally and economically while keeping in mind the interests of the society. Therefore, it has been confirmed that society is changing rapidly and that the state cannot take action alone or separately from the members of society, because for that people are needed who would command information and who know how to use it and therefore expect an economical and efficient use of state assets.

The problem is that in contemporary society information is accessible to everyone and has become a source of power. The authority is affected by certain minorities who are able to sell their ideas to others, in other words there is a group of people who are able to substantiate their proposals and these ideas get to be employed (Weber 2002, 78). In the situation where the source of power is the skill to tilt accessible information in the wished direction, it is very important to have control, which would function as both preventative balancing and subsequent control.

Estonia shares the concept, which has rooted in contemporary Europe that the state has to guarantee the rights of the minorities and promote integration of different ethnic and social groups into Estonian society. In addition, the Republic of Estonia has to take into account the changes that followed joining the European Union. These requirements affected the principles of control either directly or indirectly. That is to say that the joining was followed by additional quality requirements for the auditors of the public sector who have to be able to conduct audits on an international level. If today there are some conflicts based on competency or functioning inside the Estonian control institutions, Estonia will not look like a well-developed state to the European Union.

Estonia is a state with a parliamentary democracy, where the Parliament, the Government of the Republic, and the justice system are arranged according to the principle of the separation and balance of powers. This has created a legal system, which includes both the functioning of civilian institutions and armed forces, shaping relationships appropriate to a democratic state between the civilian and military structures. The principles of democratic control over armed forces are determined by the Estonian constitution and other legislation of national defence. Thereby the rights, duties and functions of the Parliament, the President, the Government of the Republic and of organising national defence are determined.

The principle of the separation of powers (Merusk, Narits 1998, 16–21) requires strict a definition of the competencies of the institutions of the different powers,

while keeping in mind the principles of legality. The purpose of the separation of powers is to limit the discretion of the authority of the state and constituting it into a judicial framework. According to the theory of the separation of powers, one state authority controls others and if they exceed the authority they are influenced into changing their actions. One of the purposes of the separation of powers is to avoid the dominance of private interests in the exercise of official authority (Uibopuu 1994, 51).

In the contemporary rapidly changing society the important keywords are the ability to adapt and the ability to learn, which help the National Audit Office to support positive developments in the public sector. Retaining competence requires constant professional self-education from the auditors and specialisation in their field of auditing. This issue is topical due to the limited circles of qualified and experienced people and the fact that there is not much hope for progeny, as the contemporary labour market does not enable it. Also the issue of the quality of the audits conducted has become more and more topical. [3]

The principal values of the National Audit Office are closely connected with the principal values of a good auditor. Principal values are values of which none should be overemphasised or underestimated. It is very important that the auditor does not try to leave the impression of having specialised knowledge or experience, which he/she does not really have. He/she has to also be careful while conducting the audit, monitoring and controlling the quality of the audit and compiling the audit report. Therefore, retaining competency requires constant professional self-education.

In addition, due to joining the European Union, the auditors of the public sector have to be able to conduct audits on an international level. The European Court of Auditors is interested in the strength of the National Audit Office of Estonia as the latter is, from their point of view, the internal auditor of Estonia[4]. Therefore, there have been compulsory additions to the duties of auditors, for example, financial audit and structural-aid audits. Thus, there are new challenges waiting for the auditors of the public sector, which hopefully develop and make the work of the control institutions of the public sector more efficient and the workers more competitive.

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[3] Konverents "Avaliku sektori siseaudit Eestis 2010" 06.12.2006. Arvutivõrk. Kättesaadav www.riigikontroll.ee, 12.11.07.

[4] Lätti, P.: Euroopa Liiduga liitumise mõjud auditiruumile: kontroll suureneb. Arvutivõrk. Kättesaadav www.riigikontroll.ee, 12.03.07.

When dealing with control institutions it is important to find out how the controller uses power. As it is obvious that power relations pervade the whole society, the connections between control and authority are important also. Does the anonymity of power in this relationship affect the association or not? It has been said that the more anonymous the power is, the more specifically it rules, in other words, anonymous power controls people through individual classes[5].

The new situation in the development of society has brought along many questions besides the aforementioned. Namely, the question of who is the controller in contemporary society arises. It is obvious that the legitimacy of state control is possible only when the connection between the people and the state is constant. The people wish to have a sense of security that the state where they live has effective state management and the state assets are not misused. The state has been created mainly for the people and its purpose is to help the citizens of the state to live better.

Therefore, it can be said that at first there were the people and everything social, including the state, the leaders of the state and justice, are secondary and created for serving the people. The basic principle of democracy is taking everyone's interests into account and consequently aspiring towards a consensual agreement, which would satisfy everyone (Maruste 1997, 66). Thereby giving feedback to the people by an independent control institution and giving information about whether the state assets are used economically, is an important sign of the functioning of the state in the case of democracy.

Democratic control expresses itself mainly in the nature of the relationship between parliament and executive power. In this part, the Parliament of the Republic of Estonia has a clearly dominating constitutional status, namely it can, consequently to the requirements of democracy state an expression of no confidence to the government, interpolate national officials, including the Auditor General and form Committees of Inquiry for examining specific issues. In addition to direct parliamentary control it is important to have democratic control by other independent constitutional institutions like the National Audit Office and the Chancellor of Justice (Merusk, Narits 1998, 138–142). In the case of the National Audit Office we are dealing with an institution somewhat distanced from the parliament, therefore its role is to give further security to the people about the actions of the national authority. Economic control is important due to the assets it controls, which enable the use of experts for conducting the audit.

[5] Michel Foucault (1926-1984). Arvutivõrk. Kättesaadav http://lepo.it.da.ut.ee, 12.10.07.

As with all activities, so does the question of conducting control over the auditors themselves – who would control the controllers? – arise in the case of auditing and economic control. The given question raises adverse opinions as the objectivity and legal independence of control institutions and by that also the authority and legitimacy of the results of the control is always questionable.

The answer to this question depends partly on the sense of truth and how it changes with time. If the truth is negotiable, can then the conducting of control in society be also negotiable? Negotiable in the aspect, that if the parties have agreed, that control means the existing system with its institutions and functions, then who would be the third party who could oppose the results of the control? It is possible to agree with the statement, that the truth is negotiable [6] and it is obvious that the meaning of control and monitoring is constantly changing, thus creating scientific interest and is it worthy of investigating how the principles of control have changes and why they have changed, but certainly it cannot be wholly agreed upon that control can be negotiable. Rather the basic principles of control have been the same through time and have been perfected through the development of society.

Therefore, as the existing system of control has developed in the conditions of industrialism, then in the contemporary information society the control principles are based on are questioned with reason. This is also affirmed by the rapid development of the Estonian economy during the last few years, which has unbalanced the society. The balance is off between manufacturing and consuming, material and intellectual values, economy and education, laws and ethics. As a result of the control the estimated revenues do not accrue to the state budget and most of the strategically important domains are underfinanced. Furthermore, in some domains the finances of the taxpayers are carelessly wasted. The control enables the detection and elimination of these inconsistencies. Also, the control plays an important part in inuring to the benefit of administration, and as a result of the control, administration is affirmed about the quality of its activities and in the case of deficiencies it can correct them immediately.

Throughout history the competence of the National Audit Office has been the basis of many conflict situations, for example the audit of the rouble-exchange, where the National Audit Office detected many deficiencies. Likewise there had been forged documents, which had been compiled later than the document stated. The National Audit Office transmitted the information to the investigative body for it

[6] Truth. Online. Available. http://plato.stanford.edu/entries/truth, 30.11.07.

to apply the appropriate measures. The economic police refused to commence criminal proceedings, stating that the case does not have the necessary elements of a criminal offence and the case was left practically unsolved. [7] Without a doubt it was a scandalous situation, in which the case of commencing criminal proceedings would have damaged the reputation of the Republic of Estonia in the eyes of the people. In this situation the National Audit Office had used all the possible measures given by legislation, but the wished substantive resolution of the case did not come.

In Estonia the National Audit Office does the independent monitoring of public finance and I find that institutionally it should stay that way. But, I do not exclude that there should be changes made in the direction of expanding the competence of the National Audit Office.

The main problem of the current system of the National Audit Office is not the weak work done by the institution, but rather the limited outputs caused by legislation. The officials of the National Audit Office conduct extensive audits and analyses of the use of state assets and bring out problems and proposals to change the system.

Often the facts are only acknowledged and the files begin to collect dust on the shelves. Also, it is told by the media that the National Audit Office discovered these and these state initiations to have deficiencies, but there is no specific solution of how to eliminate these deficiencies. For example, in 2003 three audit-reports were transmitted to investigative bodies but there were 74 audits conducted during that year.[8] From this ratio it can be deduced that despite the total number of audits conducted in a year, the role of the investigative bodies in solving their outcomes is minimal.

While covering the aforementioned, it seems that the problem arises in the situation where the prescriptions of the National Audit Office are rejected. Today the situation is that the National Audit Office itself is unable to enforce additional measures. So, this field needs renewing. It has been said that it is not possible to include enforcing sanctions, in the case of not fulfilling the prescriptions to the competence of the National Audit Office, as it would be in conflict with the democratic state and the principle of the separation of powers. But where does the National Audit Office belong to according to the separation of powers?

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[7] Hr Hindrek Meri. Interview with the author 21.03.2003.

[8] Sven Soiver.E-mail correspondence (06.04.04). Sven.Soiver@riigikontroll.ee

While writing the current paper I have come to the understanding that it is independent and does not fall into a specific classification. Therefore, it is possible to expand the competence of the National Audit Office in the field, as it is obvious that its status today is insufficient and the Republic of Estonia should be interested that the control over the public sector would be strong and effective.

In addition to the economic control in the Republic of Estonia, other examples of independent economic control institutions are the economic controls of Austria[9] and Hungary[10]. But as the highest economic control institution there can be an institution fulfilling the function of the judiciary, as is the case with the French [11] economic control, where the members of the economic control have judicial immunity. Another specificality of the National Audit Office of France is that it has been given judicial functions. For this purpose a separate court is formed, who also assist the parliament and conduct control over the usage of the state budget. While detecting important deficiencies or errors in management, the institution filling the role of the National Audit Office is able to immediately enforce appropriate sanctions (Dadomo, Farran 1996, 103). Besides France, the right to enforce sanctions is given to the economic control for example in Greece and Lithuania.

The most distinctive economic control is the council of economic control in Germany, where the institution does not have the function of judicature, but where the members have judicial immunity. [12] Regardless of the differences, all aforementioned economic controls are characterised by independence from the administrative system.

As an exception the Swiss economic control can be mentioned, as it is closely connected with the administrative power and the National Audit Office subjects to the Ministry of Finance and the independence of the economic control is guaranteed by the Constitution and other legislation of the field. [13]

The comparison of the higher economic control institutions of the states, and also comparing them with other economic control institutions of the state, creates

[9] The Austrian Court of Audit. Online. Available www.rechnungshof.gv.at, 30.11.07.

[10] State Audit Office of Hungary. Online. Available http://www.asz.hu, 30.11.07.

[11] Cour des Comptes. Online. Available www.ccomptes.fr, 12.07.07.

[12] The Bundesrechnungshof. Online. Available www.bundesrechnungshof.de, 30.11.07.

[13] The Swiss Federal Audit Office. Online. Available www.sfao.admin.ch, 30.11.07.

serious doubts in that if the National Audit Office of Estonia has constantly been in different competence-based conflict situations, then is the current position of the economic control and the range of its competence reasonable and should it not be changed, and in which parts should the change occur and should it be extended.

The exercising of state authority works through the functions of the authority of the state, which are legislation, and the execution of legislation and administration of justice. Still, many functions the state authorities have to fulfil do not fit into the aforementioned categories. For example, in the case of the control function it can be said that it is not directly connected with the three aforementioned functions, but is necessary for the operation of the state. Thereby the control function can be said to be the legitimising or trusting and justifying function.

Still, when looking for an answer to the question of expanding the competence of the economic control, it is important to keep in mind that the Constitution has fixed a range of competence for all national authorities, which is particularised by the legislation regulating the specific institution. The questions of expanding the competence of institutions has been under review at all times, as it is important to keep in mind that the expansion of the competence of one institution would not cause a contravening with the competence of any other constitutional institutions.

The analysis of the independence of the National Audit Office has created many debates and discussions [14] over whether we can talk about independent institutions when the state is connected with the structures of the European Union, the principles of the European Union, and are subordinate to the legal regulations of the union. When covering the independence of the National Audit Office, it has to be agreed that in analysing the contemporary relations of society and interpreting legal regulations, the specific situation has to be kept in mind. The issue of the independence of the National Audit Office is significantly simplified when we apply the elemental postulate of post-modernism, that there is no absolute truth and that truth is negotiable.[15]

Therefore, it is not reasonable to seek absolute truth when analysing the concept of independence, or in other words, it is not possible to find out which economic control is more independent, the French, the Estonian or the German control. Rather the other national control institutions and the other national authorities

[14] Konverents "Avaliku sektori siseaudit Eestis 2010" *Op cit:*.

[15] Truth. Online. *Op cit:*.

should be taken into account when determining the concept of independence in the case of economic control institutions, and it should be examined how extensive is the jurisdiction of the economic control itself.

In addition to the problematics of the concept of independence, the range of the control conducted should be covered. When dealing with control and monitoring, the problem often is that the control is conducted maximally in the ruling structural unit, but not enough attention is given to lower sub-units. This is very obvious in the control over ministries and other budgetary state agencies: the lower the authority the smaller is the function of the control.

For example, when investigating the judicial problems of the activity of the National Audit Office in the Republic of Estonia, it comes out that the state control over local governments is insufficient[16] and it creates discontent among the population, moreover the investigations have proven the inefficiency of the internal control in local governments. Therefore, it is very probable that the most damage to the society can be done by the institutions lower than the ruling authority, due to absence of control.

The efficiency of the National Audit Office in controlling state authorities is also problematic. For example, the National Audit Office has the right to make proposals for eliminating deficiencies and, if necessary, to transfer the control-reports to investigative bodies, who can give an evaluation of the case in accordance with criminal law. The monitoring by the National Audit Office lies in that when an accumulation of deficiencies is detected in the domain of an institution, then it makes the National Audit Office observant as it can be deduced that the aforementioned institution is having trouble with organising its economical activities and it should be thoroughly controlled during the audit.

There have been cases when the National Audit Office conducts an audit in the investigated institution, detects several deficiencies which should be eliminated, and makes its prescriptions to the institution but nothing changes during time. The National Audit Office transfers the materials to an investigative body in order to take the necessary action, as the National Audit Office itself cannot enforce sanctions and the sanctions cannot follow automatically to its actions. The aforementioned is grounded on the fact that the control done by the National Audit Office helps

[16] Kohalike omavalitsuste valdusse antud riigivara kasutamine ja käsutamine. Arvutivõrk. Available at: http://www.just.ee/10740, 25.10.07.

the institutions to organise their activities and is informative to the superordinate organisations of the institution about the work of their subordinates. As the analysis of the institution and the competency of the National Audit Office[17] has shown, the range of competency stated by the Constitution is not sufficient, therefore I find that in the field of conducting control, the competency of the National Audit Office should be extended and if possible, the National Audit Office should be given the right to enforce sanctions.

In addition, the analysis of economic controls of different states affirms that the right of the economic control to enforce sanctions is not an entirely new method in the field, but it is widely used in many democratic states, for example France, Greece and Lithuania. In addition, the Lithuanian experience has affirmed that in a situation where there are many economic crimes, this method of control has justified itself (Niitra 1996).

Therefore, as one possible solution I find that the competency of the National Audit Office in the given field should be extended. Namely, extending the competency of the National Audit Office in enforcing further sanctions should be taken into consideration. The right to enforce sanctions independently would be one of the most important leverages of independent economic control, which would benefit the efficiency of the National Audit Office. Still, the system of enforcing sanctions needs specifying and the questions of what measures can be taken and to what extent would the National Audit Office have the right to enforce sanctions must be solved. Therefore, the given issue needs additional discussion and analysis, which cannot be solved in detail in this paper.

In Estonia there are control and monitoring institutions created in order to receive feedback. The institutions have given necessary feedback on the activities of the state institution. Despite this, the rapid development of society has created many issues on the part of control and monitoring, which need more specific and detailed analysis in the future. It is important that Estonia has to advance on the conceptual level and has to adopt all methods of developing an effective and sufficient system of control and monitoring.

[17] Eksperdiuurimus Eesti Vabariigi Riigikontrollis 1999 ja 2005. *Op cit:*.

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The financing of research libraries in the context of the organisations of the Estonian public sector

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Libraries and public interest

The role of libraries and its changes, depending on public interest can be evaluated from different aspects, such as :

- which is part of the norm documents of a library in relation to the political, public, and administrative environment;
- how does a library change according to changes in society as a whole;
- the library as an intersection in a multicultural and digital environment;
- different economic models of libraries (Audunson, 2005), etc.

Traditional values related to public administration emphasise primarily stability, predictability, continuity and certainty (Metcalfe and Richards, 1993).

But the time of management has arrived also in the public sector. Economic pressure and the decision of the Estonian Republic to decrease the expenses of the state budget in 2008, compel one to seek ways and possibilities how to improve the functioning of public organizations, including libraries. The National Library of Estonia is forced to decrease its opening times and to make layoffs because of the budget cut in 2008. Other libraries also have to centralize their activities – the following years promise to become budget saving years.

Therefore, the aim is to value more the resources that are in use. Several approaches have been used to extract the maximum outcome from a small set of resources. The attempts at reform are aimed at saving or increasing the efficiency of work performance. This often brings along extensive organizational changes, such as decentralization, or reforms of financial management, the establishment of values among public sector employees, which create higher price awareness, stronger orientation towards service providing or an increased aspiration to take

responsibility for the results. An improved management of the public sector is vital in achieving greater degrees of cost-effectiveness, efficiency and expertise in the shorter as well as longer perspective. Virtually every organization of the public sector has room for that performance. Reducing costs could have a great impact on the organization and its management, as it reveals weaknesses and inadequacies, which could be concealed and tolerated in better conditions (Metcalfe and Richards, 1993). Transformations in the economic and political spheres of the society and in information technology produce the need for changes in the functioning of research libraries.

Legal persons in public law are public sector *de jure* independent subjects, forming the organization of the public sector (Haldma, 2005). The organization of public administration centralize legal persons in public law and other legal and physical persons to whom legal persons in public law have given over the fulfillment of some public tasks, including, for example, the provision of library and information services by local government to public libraries, etc. (Valm, 2006).

The library, as an organization of the public sector, performs functions, which are vital from the perspective of large groups of people or the society as a whole. Libraries might belong to the organization of public administration as legal persons in public law (for example, The National Library of Estonia), as institutions of a legal person in public law or its structural units (university, libraries, public libraries, libraries of state institutions, and schools) or structural units of a legal person in private law performing public functions (the library of the NGO, Estonian Centre for Standardization).

In Estonia, (in addition to different forms of ownership – municipal, state and legal persons in public law, also, for example, private university libraries as private ownership) libraries belong to the domains of different ministries (mostly to the Ministry of Education and Research and to the Ministry of Culture), which has aggravated the changeover from formal developmental plans to the rationale cooperation of libraries because of a relatively rigid formal financing policy. The Ministry of Culture supervises the network of libraries all around Estonia.

In Northern Europe, libraries form an essential part of the state infrastructure, however, the activities of Estonian libraries have been regulated by a number

of legal acts, but an important set of aspects related to activities of financial economics have remained unregulated in the legislation up to today (Valm, 2006).

The management of libraries have to observe and compare their results with similar organizations in order to be informed enough to make and apply decisions to enable science libraries to support science and study, the education of the population, and to assure accessibility of information necessary for the development of the state and society.

The aim of the present article is to analyze the principles of the allocation of resources and the financial management of the research libraries belonging to the Estonian public administration system and the common completion plan of science libraries discussing the agreement about possible causes of malfunction between libraries. In the empirical part of the article, the differentiation of income and expenditures in 2007 are analyzed in the case of four major Estonian academic libraries – the National Library of Estonia (NLE), the Tartu University Library (TUL), the Tallinn University of Technology Library TUTL) and the Academic Library of Tallinn University (TUAL). These four libraries were chosen because the critical mass for fulfilling the tasks of science libraries has been formed historically in these libraries. Annual data presented to Statistics Estonia and the activity reports of science libraries are the basis of analysis.

In a number of developed states (primarily Anglo-American counties), the economic activities of universities, theatres, health care institutions, religious organizations, etc., are considered as activities of non-profit organizations or of non-for-profit organizations. Until now, this concept has been absent in Estonian legislation (Haldma, 2005). A convincing proof of that is the library reform carried out in Estonia after the reinstatement of independence. With the transfer of libraries to local governments in public law, the rights of decision-making were granted to the local people, as the direct users of the services of these libraries, thus avoiding the massive liquidation of public libraries (for example, what occurred in Latvia). University libraries were transferred from state ownership to the ownership of universities in public law, which, considering the specific needs of universities regarding academic and research activities was the only possible solution (Ottenson, 2008). Now they have gained the status of science libraries.

The National Library, performing the triple function of a national, parliamentary and research library, changed its status from state institution to a legal person in public law. Based on the rights and legal capacity of the latter, the National Library has become the coordinator of the Estonian public information space. This has been possible due to the library's right to plan its own work, to develop and confirm its budget, to decide upon its structure and workplaces, to make independent management decisions, to sign contracts, to use and manage its own land, premises and assets (Ottenson, 2008). But is this all so positive? In May 2008, the council of the National Library of Estonia confirmed the cuts in the budget of 2008, because of the reduction of the budgets of organizations governed by the Ministry of Culture, which diminished the support for activities of the library from the state budget by 3% or 2,825,614 Estonian crowns. The budget of 2009 remains also at the level of the year 2007, assuring only the monetary means needed for necessary functioning.

The function of the public sector is to increase products that the market doesn't want to produce at all or produces insufficiently. A certain kind of information can be considered also as a public product and the public sector is responsible for its accessibility. Everyone has the right to get information that is for general use (Fundamental Law of the Republic of Estonia, 1992). In order to assure this freedom from Fundamental Law the state has created a necessary base of legislation and a network of institutions in order to assure the function of this system – these are libraries.

The public tasks of libraries originate from public interests, which is the sum of a state or community member's private interests. The constant supplement of public information resources of libraries, adapting to the changing needs of society, assuring the accessibility of information in the most convenient way for people, and certain quality and quantity of library and information services, are also in the public interest (Valm, 2006). Specifying the set of rules pertaining to the rights of legal persons in public law and improving the mechanisms of their functioning would significantly increase the effectiveness of the activities of libraries as the bearers of public administration, boost cooperation between different types of libraries, strengthen the foundations of activities related to financial economics and eliminate duplication, that is, would enable to make better judgments from organizational and economic perspectives (Valm, 2006).

One of the most important research done in order to regulate the legislative situation of European libraries was carried out in 1994-1995 by the European Commission – *Reform of library legislation in central Europe* (Vitiello, 2000), the method of a case study analysis was used. Long-term orientations were determined concerning the results of this study, such as:

- approach, unification. On one hand, differentiations of different types of libraries are diminishing, on the other hand the possibility to use different information sources are broadening;
- globalization, with explicit broad use of international databases and systems from the libraries. Close cooperation between libraries is important;
- participation. Libraries are always closely related to society, because they satisfy a citizen's cultural and educational needs (Library Legislation in Europe, 2000).

The Financing of Research Libraries in Northern Europe and Estonia

The financing of libraries is problematic all around the world. Digital development in the sphere of information requires constant technological updates and consequent expenses. It is especially problematic for research libraries (Nuut, 2000).

Research Libraries in Northern European countries

In Northern European countries, libraries are an essential part of the state infrastructure, their information systems are financed and services offered by them are developed by programs approved on the state level (Library Legislation in Europe, 2000).

In Finland, the structure of the library system is a top standard and valued all over the world. Nearly 80% of Finns use library and information services regularly. The Ministry of Education regulates the functioning of Finnish academic and primary research libraries and the development of info-technological activities is coordinated by the National Library (Helsinki University Library). The establishment of the Finnish electronic library (FinELib) was initiated by the Ministry of Education in 1997. Since 2000, the development of the electronic library takes place at the National Library with target financing. 95 libraries and research organizations all over Finland are at the moment members of the FinELib *(Ministry* of Education of Finland Website, 2007).

In Sweden, it is the responsibility of BIBSAM, the department of national co-ordination and development of the Swedish Royal Library (Swedish National Library) to develop national information and library policies. In Sweden, a nation-wide well-functioning cooperation between different library sectors has been established, taking into consideration the financing of public, research, special and school libraries, the market for services, as well as interlibrary loans. However, there are difficulties with developing a nation-wide electronic library, as the decentralized system obstructs the financing of large joint projects (National Library of Sweden Website, 2007).

University and research libraries in Norway are as a rule part of the structure of universities and research institutions respectively, and are under the jurisdiction of the Ministry of Education, Research and Church Affairs. The National Library of Norway is responsible for complying with the Deposit Copy Act and is under the authority of the Ministry of Culture, which has organized a network system between libraries, museums and archives (*Kulturnettet*), with the aim to make their resources freely available for the consumers of information (The Norwegian Archive, Library and Museum Authority Website, 2007).

The Danish National Library Authority in cooperation with the Ministry of Culture is responsible for the development activities of libraries, and thus also for the formation of library policy. Libraries, museums and archives are state institutions under the jurisdiction of the Ministry of Culture. All research libraries are state institutions under the administration of the Ministry of Culture (i.e. The Royal Library, State and University Library), the Ministry of Education (Danish National Library of Education), or the Ministry of Research, and are financed by the state (Danich National Library Authority Website, 2007).

Research Libraries in Estonia

As an exception, the development of the information system of Estonian libraries is not included in the national program for the development of the information society.

The library network in Estonia is formed by the:

- national library;
- university/academic libraries, which also function as research libraries;
- libraries of other higher education institutions;

- public libraries;
- school libraries;
- special/workplace libraries.

The research library is a library offering public service, whose task it is to gather, conserve, process and make accessible to all interested groups scientific information, whose tasks have as their basis science and development activities (TAKS, § 41 paragraph 1). Science libraries acting as legal persons in public law are autonomous independently fulfilling science, education, and cultural institutions, which act on the basis of science and developmental activities. The aim of the library as a research library is to satisfy readers' needs for scientific information. The aim of school libraries as legal persons in public law is to support high-quality education. The aim of these libraries is to assure the accessibility to information important for the development of the state and society, predispose science and developmental activity, the educational level of the population and general growth of education, and to increase the state potential of science.

In 2007-2011, libraries acting near universities of legal persons in public law were named research libraries: University of Tartu, University of Tallinn (both also perform the functions of depository libraries), Tallinn University of Technology, the Estonian University of Life Sciences, the Estonian Academy of Music and Theatre and Estonian Academy of Arts. This choice is logical, as the primary research and development activities in Estonia are conducted in these universities and their libraries have historically generated critical mass for functioning as research libraries. In addition, the National Library of Estonia fulfills certain research and archive library tasks, although it is not named as a research and archive library. The National Library of Estonia has the status of a science and development institution in the framework of valid legal norms and therefore presumption for better financing of innovation has been created (Completion of research and archive libraries, 2007).

Monetary means are allocated to the research libraries to acquire research materials and to archive libraries to acquire national materials according to the proposal of the Estonian Government and to the state budget (Completion of research and archive libraries, 2007).

The National Library of Estonia is a legal person in public law created by the act of National Library of Estonia and it functions in the domain of the Ministry of Culture as an information, science, development and cultural institution and uses for the financing of its activities the state budget's appropriation for intended use as well as means from its own income and other resources that are added.

University libraries as research libraries are a part of the structure of universities and plan the aims of the activities and priority development tendencies in accordance to the developmental plan of universities, but are still essentially independent.

More than 6 million materials are in research and archive libraries and more than 200 million Estonian crowns are spent on new materials and to assure the condition of conservation per year. Mostly the budget of the National Library of Estonia forms this sum, much less goes to the archive library of the Estonian Literature Museum and to university libraries to buy materials. An average of 58,000 publications and 800 information materials are added to libraries per year, which belong to permanent collections (Completion of research and archive libraries, 2007).

Valuable information resources are stored in the libraries of other universities, including those of private universities, such as the library of International University Audentes (**On 1 July 2008, International University Audentes merged with Tallinn University of Technology)**, which operates as one of the two European Documentation Centers (EDC) since 2004, in Estonia (another one is Tartu University Library), and belongs to the global network of European Documentation Centers. The main function of EDC is to support academic and research activities in the university, as well as to assure the accessibility of European Union materials to all visitors (European Commission: European Documentation Centres, 2007).

The legislative regulation of the activities of research libraries in Estonia began in spring 2001, when the concept and tasks of the research library were defined in the amendments of the Arrangement Act of Science and Development Activity and enacted the state obligation to finance the acquisition of scientific information via the budget of the Ministry of Education and Research. The Council of rectors of universities as legal persons in public law and the council

of research libraries, where directors of research libraries named by the Estonian Government, the director general of the National Library of Estonia, representatives of the Ministry of Education and Research and Ministry of Culture, deal seriously with state financing questions of research libraries, coordination of completion, composing of developmental plan and joint projects (Järs, 2005).

But do research libraries guarantee accessibility for the necessary scientific information and can they create complete and permanently conserved collections as economically and effectively as possible from publications important to Estonian national culture?

Requirements for research libraries were set by the regulation of the Minister of Education and Research in January 2002. Regulation started to function in 2003, when 18.9 million Estonian crowns were allocated from the state budget for the acquisition of scientific information. This constituted a turning point in the funding of research libraries, as previously, universities had to allocate resources from the scarce funds for level studies in order to purchase scientific information. However, certain tendencies, which decrease the effect of the extra financing, have occurred: according to the new Value Added Tax Act, enforced since May 2004, 5% VAT is to be paid on the purchase of printed journals and 18% on the purchase of electronic resources. The usage license fees for electronic resources and prices of printed books and journals continue to rise, as a result of which, acquisition funds need to increase annually, in order to ensure that the libraries maintain current levels of acquisition (Järs, 2005).

In the beginning of 2004, research libraries and the National Library of Estonia compiled a joint mapping of acquisition topics, which shows the depth of acquisition on two levels: information supporting research and basic information (Sürje, 2004). Every year libraries present to the Ministry of Education and Research their own completion program, which is the basis for the final version – the unified completion program. 35 million Estonian crowns were distributed to research libraries of universities from the state budget from the expenses of education in 2008.

In spite of the fact that the obligation to compose a unified completion program was validated in 2004, there isn't concrete agreement about its content and aims to

date. The council of research libraries takes the position that the joint completion program could be an agreement between libraries as an ideal, which describes, who completes what and what cannot be completed by whom in order to form one Estonian research library at the ***world's top level***. It would help to save resources a lot (Completion of research and archive libraries, 2007).

Therefore, the unified completion program of research libraries, which was created to regulate and coordinate the procurement of scientific information and to regulate the financing, doesn't work. Until now, connections with curriculums of universities and scientific and applied research are missing in the completion program in some cases. There aren't exact agreements on how to compose it and therefore it is not possible to be sure that complete distribution of research libraries is optimal and can avoid duplication. Maybe the efficiency of the RVL system between Estonian research libraries should be considered more, which would allow lending scientific literature with fewer issues also for a short time.

As a coordinative organ is missing that could evaluate the relevancy of the named program in every library, then a calculation of the completion program as a possible basis for financing is questionable. Optimizing the completion of research libraries has to be worked through comprehensively according to the needs of Estonian science and higher education and to the economy of resources.

Collections, usage and financing of the largest Estonian research libraries in 2007

The value of the research library is traditionally measured mainly quantitatively according to the indicators – size, capacity, spending etc. Gathering, systematizing and analyzing statistical data is also important nowadays. Libraries need statistical information in order to evaluate the results of their activities, to make further plans and developmental plans, and to realize their strategic aims. Year by year data about activities and resources of libraries is gathered according to the standard of international library statistics originating from the National Statistics Act (EVS-ISO 2789:2007 Information and Documentation. (International Library Statistics).

Statistical data of different types of Estonian libraries is gathered and preserved in the library's statistical database of the Science and Development Center of the National Library of Estonia. At the same place the controlling, processing and analyzing of the data and working out and modernizing the basis of gathering data happens.

Table 1. Essential Data about Estonian Academic Libraries in 2007

Library	Collections on physical carriers	Electronic collection: licensed databases	Registered users	Visits	Virtual visits
National Library of Estonia	3 187 674	49	51 346	163 796	499 583
Tartu University Library	3 766 958	106	46 246	422 763	-
Tallinn University of Technology Library	733 486	76	19 251	247 263	5 749 833
Tallinn University Academic Library	2 535 320	44	43 770	267 399	-

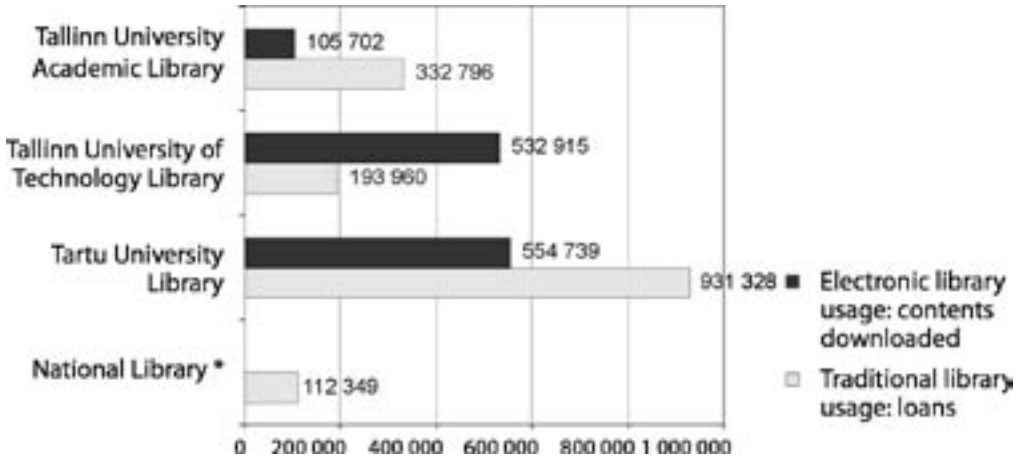
Source: ***Estonian Library Statistics Database***

Unfortunately, it is not possible to compare side by side the number of physical visits in Table 1 to the number of virtual visits between libraries. The reason for this is that Tartu University Library and Tallinn University Academic Library haven't thought it necessary to reflect these numbers in statistics. To explain this situation, amount of times users turn to the homepage of the library outside the library are determined as virtual visits, and virtual visits can be compared with traditional library visits by EVS-ISO 2789:2007. The interval of two sequential enquiries shouldn't be longer than 30 minutes; longer intervals initiate a new virtual visit.

Comparing Table 1 and Figure 1, it can be seen that depending on the financial possibilities of the research library, but also depending on the different ways of registration and accounting of loans (for example, NLE doesn't lend publications to take home, exceptions are made only for some state and constitutional institutions, with whom the library has made contracts. There are also deficits in accounting the e-content units - articles and résumés), the number of loans (traditional loans and also information from the database) per one person is very different: the National Library of Estonia – 2, Tartu University Library – 32, Tallinn University of Technology Library – 38 and Tallinn University Academic Library – 10. The NLE should definitely look over the license contracts of bought databases, which motivate the giver of the license to

present the correct statistics. As all these named research libraries serve the whole population, not only their own students and lecturers, then the structure of readers isn't registered in the database of Estonian Library Statistics, rather the data is limited to the whole number of readers.

Figure 1. The usage of the collections of Academic Libraries in 2007.



Source: Estonian Library Statistics Database

** The number of downloaded content units in bought databases isn't registered in NLE, only the number of searches is registered*

Legislation that regulates the activities and finance resources has the greatest impact on the autonomy of the library. Multiplicity of finance resources and the freedom to use resources define the autonomy of the organization in a monetary sense. A library with many different finance resources acquires a greater right for decisions than a library whose money comes only from the state budget.

The financing and revenues of legal persons in public law originate mainly from three sources:

1. the means of state and local budget;
2. donations/intended for use in target financing;
3. independent economic activities or so-called "own revenues" " (Haldma, 2005).

The aim of composing the budget of the library is to determine the sum of financial means that are necessary to cover the maintenance and development

costs of the library. The basis of the analysis of the empirical part of this current article is the database of Estonian libraries statistics, which is worked out according to the standard of international library statistics (EVS-ISO 2789:2007) and, therefore, the following tables and figures present the income of research libraries in 2007, in accordance with the distribution of the standard and database.

The activity expenses of research libraries begun their finance from the state budget and this achieved situation is worth mentioning, particularly in 2007. The new line, with 35 million Estonian crowns per year, was established in the state budget. The Ministry of Education and Research allocated 19,580,000 Estonian crowns for financing the completion of electronic databases of Estonian research libraries to the NGO Consortium of the Estonian Library Network (Directive of the Estonian Ministry of Education and Research No. 293, 2007).

Table 2. The Income of Academic Libraries in 2007 ((% from gross income)

TOTAL INCOME	**NLE**	**TUL**	**TUTL**	**TUAL**
Income from university budget	0	71%	60%	36%
Income from state budget	87%	22%	28%	60%
Special-purpose assignments from EU projects, enterprises, private persons and grants from the Estonian Capital of Culture, from the Estonian Information Technology Foundation et al.	4%	3%	11%	0
Income from economic occupation	9%	4%	1%	4%
100,00%	*104 880 200 kr*	*57 442 200 kr*	*27 841 600 kr*	*26 055 000 kr*

Sources: Activities Reports of Academic Libraries, Estonian Library Statistics Database

Table 2 shows that the state finances from the largest university libraries, mostly the Tallinn University Academic Library, main income of other libraries came from the university. The proportion of target financing is greatest in the Tallinn University of Technology Library, missing completely from the Tallinn University Academic Library and is least in the Tartu University Library. The main income of the National Library of Estonia comes from the state budget. The year 2007, was

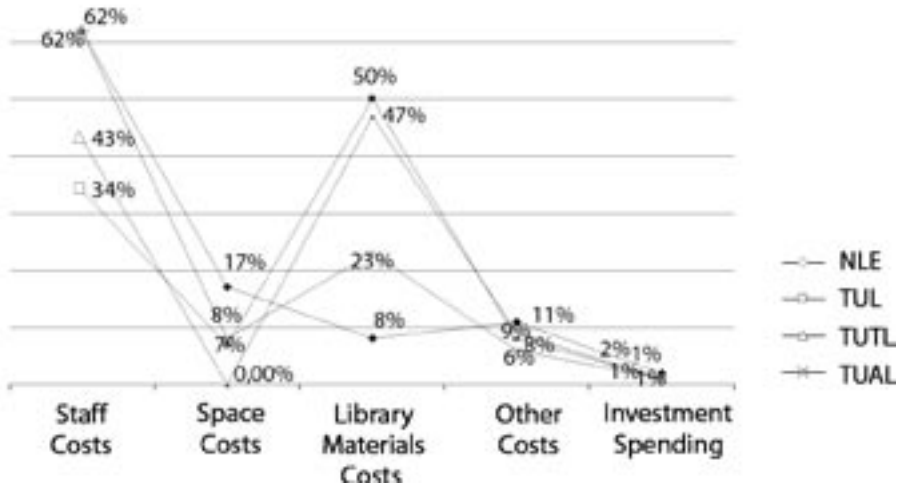
economically complicated for the National Library of Estonia and the budget was very intense. The level of main services of the library was preserved only because of the growth of income from economic activities and the stability of the finances of intended use.

Although usually the public sector doesn't offer priced services, libraries offer mostly priced services. Lending publications is for free in libraries. Priced services can be, for example, composing substantial lists of bibliographies, library borrower's card, duplication, scanning, and printing work, communication and post services (first of all, related to offering loan services between libraries), bookbinding, but also exhibition services, conference and publishing services, excursion services, etc. Their own income is one possible way to solve problems of the budget deficit, to cover deportment and activity costs, constant repair costs and the price growth of administrative costs (electricity, guards, water and sewerage) (Kuusik, 1999).

The most important part of the income is formed by the own income of NLE – 9%. NLE offers in addition to the ordinary library services also conference, exhibition and restoration services and rents rooms that are not necessary for the library to other institutions. Income from priced services is marginal in other libraries.

The expenses of the largest Estonian research libraries in 2007

Diagram 1. The Expenses of Academic Libraries in 2007.



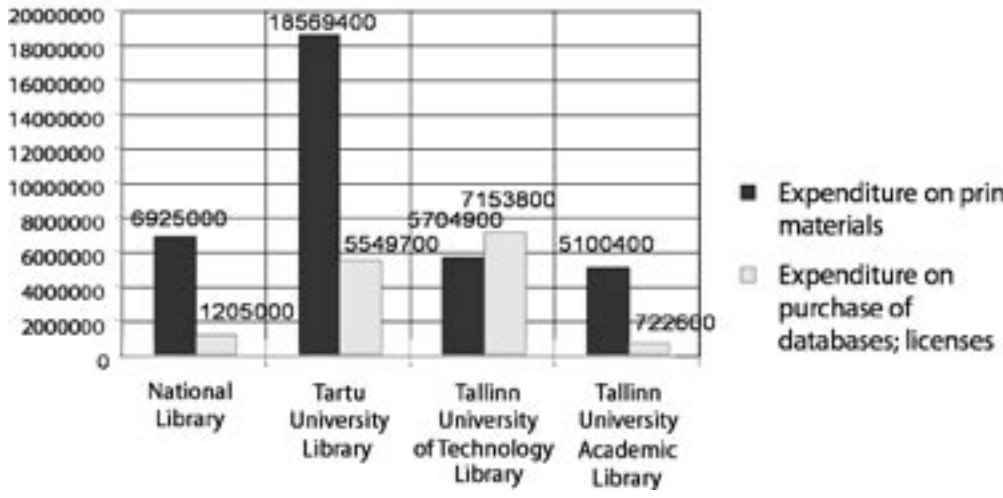
Source: Estonian Library Statistics Database

Priorities are posed and the money is planned for these tasks in accordance to monetary possibilities, the library can't exist without these – like expenses for the workforce, administration, completion of publications, investments into the building, settings and main means (which increase the value of basic assets), are also important and for the actuation and development of new services.

The percentage of workforce expenses in the budget (diagram 1) is equal in NLE (432 employees at the end of year 2007) and Tallinn University Academic Library (142 employees), lesser in Tallinn University of Technology Library (77 employees) and Tartu University Library (183 employees). Calculation of workforce expenses for one employee can't be handled as an average salary, because many other expenses of personnel development are added here like, for example, employees hired on a contract basis (gardener, employees related to some projects).

Administrative costs form an important expense article, which covers all economic expenses related to real estate and rooms. But these are very different concerning different libraries. While the Tallinn University of Technology Library is situated in the same building with the university, it is understandable that its administrative costs are in the budget of the university, not in the budget of the library, and therefore it isn't comparable with other libraries.

Figure 2. Acquisition costs of Academic Libraries in 2007.



Source: Estonian Library Statistics Database

The Research library can't exist without completion costs, which belong to the greatest main expenses (additionally to workforce expenses). We can see in figure 2 that spending on the electronic collection - bought databases and acquired licenses - were the greatest in 2007, in the Tallinn University of Technology Library and in Tartu University Library (in accordance with 7,153,800 Estonian crowns or 55,6% and 5,549,700 Estonian crowns or 23% from the completion budget). State licenses financed by the Ministry of Education and Research and co financing have been very helpful for acquiring licenses, but it's not enough, because the interests of users for e-services and e-library increases year by year.

The percentage of completion cost from the budget still isn't the indicator on which presumptions can rely that completion money is big or small, because the sums of the budget and the planning of costs is different in different years and is dependent on all kinds of circumstances. It is important to remember that when supplementing the collections of research libraries, a certain amount is formed also by procurement resources, such as gifts, donations, compulsory copies, exchange and collective procurements to buy electronic scientific databases.

When comparing the expenses of research libraries (Figure 2), the Tallinn University of Technology Library has been able to distribute its expenses most practically (completion costs and workforce expenses taking into account the small number of employees) and to address more means to the development of collections and to the appreciation of a qualified workforce.

The leading Estonian library is underfinanced, is the conclusion drawn from the analysis of financing of the NLE. Only in recent years has the wage fund increased in the budget of the NLE. The completion of publications, economizing of real estate, etc., has seen the proportion of other important expenses decrease constantly, in spite of price growth, and has started to impede seriously the achievement of the strategic aims (Activity report of the National Library of Estonia 2007, Action Plan 2008).

The low percentage of completion costs of the national library is compensated by the fact that library doesn't lend publications to take home, and therefore the appellations of examples in the collections are minimal and limited to compulsory copies in many cases. The relatively low percentage of completion costs is characteristic of the national libraries of Northern Europe (for example in Sweden 4%, in Finland 6% and in Denmark 11% from the budget (Nuut, 2001)).

Conclusion

Most libraries are positioned in the public sector because they provide services that are difficult to offer in market conditions. While citizens expect unpaid services and smooth functioning from libraries, the state assumes effective budgeting and efficient management at the same time.

Most libraries all over the world operate in the conditions of limited resources. In Northern European countries libraries are an essential part of the state infrastructure, but in Estonia the development of the information system of libraries is not included in the state program of the development of the information society.

Therefore, the question has become an actual one in Estonia and elsewhere in the world – how to provide nearly equivalent services with fewer costs? The limited resources could be used more efficiently, if the distribution of tasks between libraries could be agreed upon, to have more cooperation and to make the coordination of completion more effective. It should be kept in mind, that a budget composed according to the principles of efficiency and cost-effectiveness, doesn't necessarily mean the implementation of innovative ideas, development and renewed quality for the libraries.

The analysis of the income and expenditure of research libraries, showed, that the university and state mostly finance research libraries, the proportion of targeted financing and income from economic activities is relatively marginal. It can also be concluded that the Tallinn University of Technology Library has managed to allocate its expenditures most practically and designate more resources for the development of library collections and for the valuation of a qualified workforce, and at the same time holding administration and other costs low. The budget of the National Library of Estonia hasn't assured the strategic development of the library concerning the increased demand for new information services. Administration of the building has become more complicated because of the decay of the building, amortization of the technical network from Soviet times, and price growth of deportment costs. There has also been a problem with understanding that imposing only human capital can't last forever – a long time ago the balance between human capital (know-how, workforce, enthusiasm, loyalty etc.) and material resources has been disturbed.

In consideration of the limited capacity of this article, it wasn't possible to make closean indepth study about the distribution of library expenditures and income during the last five or ten years, which would given a more compendious picture, without doubt, about the development tendencies of Estonia's largest research libraries.

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SECTION IV: CULTURE

Alfred Hitchcock and the monstrous gaze

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Summary: *The films of the British-born director Alfred Hitchcock may be seen today as launching a radical and seminal exploration of many of the central existential and psychological preoccupations that came to dominate European cultural philosophy and avant-garde cinema in the second half of the twentieth century. Although often remembered (for the films he made in the United States) as a commercially successful Hollywood director, Hitchcock began his career making films in Britain and Germany, and later found his artistic genius first recognized by such French cinephiles as André Bazin, Jean-Luc Godard and François Truffaut.*

Today, Hitchcock is perhaps best known in academic circles through the repeated (almost obsessive) returns to his work performed by the Slovenian philosopher Slavoj Zizek. This paper examines three of Hitchcock's major works – *Rear Window* (1954), *Vertigo* (1958) and *Psycho* (1960) – through the perspectives of various European semiotic and psychoanalytic theoreticians, including Sigmund Freud, Jacques Lacan, Jacques Derrida, Roland Barthes, Michel Foucault, Christian Metz and Slavoj Zizek – and suggests that, through a sequence of disorienting reidentifications of the subject of the filmic gaze, these films expose the monstrous otherness of all those who watch: for those viewing subjects who watch Hitchcock's monstrous objects are also unwittingly the objects of Hitchcock's own monstrous gaze.

By undermining the assumed subjectivity of cinematic spectatorship, these texts suspend their audience between the viewers' and the texts' own specularity: between two gazes, between the imaginary and the symbolic, between the eye, the vagina and the grave – between life and death, and therefore (in so far as life is a mode of death, a drive towards death) between two deaths.

Introduction: the way you look tonight

"You know," Alfred Hitchcock asks French filmmaker François Truffaut during their marathon series of interviews in the 1960s, "why I favor sophisticated blondes in my films? We're after […] the real ladies, who become whores once they're in the bedroom […]. Sex should not be advertised. An English girl, looking like a schoolteacher, is apt to get into a cab with you and, to your surprise, she'll probably pull a man's pants open."

Truffaut answers, diplomatically, that he doubts most people share Hitchcock's "tastes in this matter." (Truffaut 1985:. 224)

Sometimes – like *Psycho*'s Norman Bates – Hitchcock seems like a sexually embarrassed, sniggering schoolboy, sometimes – like Bates again – a murderous misogynist. This is after all a director who repeatedly stated his desire to "knock the ladylikeness" out of those very same 'high-class' performers whose sophistication he here applauds (Truffaut 1985: 80, 248).

Where, one is tempted to ask, as so many critics have done, naïvely enough, of this master of deception, and self-deception, where might the true Hitchcock lie? Is he really the feminists' sadistic monster – or merely, so to speak, their whipping boy? Or is he simply the "guilty little boy" – the honeymoon virgin – which Truffaut proposes, and indeed he himself purports to be (Truffaut 1985: 346-7)?

Hitchcock's naked terror of female sexuality, and of (what that might expose in) his own, advances a style of cinema that is simultaneously masochistic and sadistic: the cinematic object must at once be distanced and immediate, unattainable and wanton, inviolable and violated. Above all – and indeed *because of* the frustrating yet essential suspension of these contrary imperatives (sadism and masochism) within this single desire – it is voyeuristic. It can never touch the object of its desire – such is its fear of that object and of what its desire might do to it. Yet so overwhelming is this desire that it can never quite leave off watching it. It seems revealing that in the final phrase of Hitchcock's portrait of a 'real lady', the grammatical emphasis unaccountably shifts: his ideal woman "is apt to get into a cab with *you* and, to *your* surprise, she'll probably pull *a man's* pants open." The woman pulls a third person's – *another* man's – pants open, rather than his (or his narrative's 'your') own. Hitchcock is content only to observe such events, *not* to participate in them.

In Hitchcock's *Notorious* (1946), an American agent [Cary Grant] looks on as the object of his affections [Ingrid Bergman] seduces and eventually marries a Nazi conspirator [Claude Rains] in order to spy on him. This voyeuristic process comes full circle when Rains discovers Grant and Bergman in a romantic clinch, and Hitchcock's plot spirals into a masochistic fantasy whose ostensible focus (a cellarful of uranium-filled wine bottles) becomes a virtual irrelevance.

In her study of Hitchcock's films, *The Women Who Knew Too Much*, Tania Modleski has suggested that this masochism is related to the pleasure achieved by the child in Freud's *fort/da* game: the pleasure gleaned not (as Freud thought) upon regaining the lost object, but in losing it (Modleski 1989: 69). In *Beyond the Pleasure Principle*, Freud describes his infant grandson repeatedly throwing away a wooden bobbin attached to a piece of string, and then using the string to pull it back. Freud sees the psychical dynamic for this game as a mode of compensation for the child's "allowing his mother to go away." (Freud 1984: 285) It therefore becomes a minor consolation for Oedipal loss, that is, for the renunciation of the object of Oedipal desire at the moment of the child's assimilation within the symbolic order. It is the first in a series of substitutions for the unattainable mother – as such it represents what Jacques Lacan calls an *objet petit a(utre)*. Freud, through a sequence of compulsive rephrasings strung through his essay, traces this "compulsion to repeat which overrides the pleasure principle" back towards "*an urge inherent in organic life to restore an earlier state of things*… a kind of organic elasticity" which eventually represents "the instinct to return to the inanimate state." (Freud 1984: 293, 308-9, 311) The death drive may therefore be seen as the inevitable (yet continually deferred) conclusion to the logic of symbolic substitutions for the Oedipal object: a process of equalization and reintegration of contraries; a return to the earth, to the grave, an entering again into the body of the mother, a birth in reverse.

The masochistic pleasure of cinema – a pleasure discovered not in satisfaction but in the aching yearning of unsatisfiable desire – is inspired by the voyeuristic distance, the distance which is at once crucial and anathema to the act of voyeurism – in so far as its vicariousness requires that distance, but also in so far as that distance dissolves the illusion of intimacy upon which the voyeur's imagination feeds. Without its little losses, the *fort/da* game can afford no pleasure, even though (or because) we know its yo-yo-like motion will eventually result in that irredeemable loss which we recognize as death. It's in this very inevitability that the conclusions to the stories of Oedipus and of Orpheus – and of Hitchcock's *Vertigo* – find their melancholic resonance and piquancy. The fact that Freud's grandson lost his mother shortly after his grandfather observed him playing his *fort/da* game

only intensifies and makes more urgent this sense of the inevitability of loss.

Hitchcock interestingly speaks of the voyeuristic psycho Norman Bates not in terms of the sadism one might have expected, but in terms of "masochism" (Truffaut 1985: 282). Bates is caught up in the double bind of voyeurism-masochism in which those who participate in cinema's perverse processes of imaginary identification are irredeemably implicated.

"The film," writes Christian Metz, "is not an exhibitionist. I watch it, but it doesn't watch me watching it […]. In this way the cinema manages to be both exhibitionist and secretive […]. For this mode of voyeurism […] the mechanism of satisfaction relies on my awareness that the object I am watching is unaware of being watched." (Metz 1982: 94) Yet this awareness is, of course, a false one. The camera, as Susan Sontag points out, resembles "sexual voyeurism" in that "it is a way of […] encouraging whatever is going on to keep on happening." (Sontag 1979: 12) The camera is rather less invisible and inactive than it professes to be. The filmgoer enjoys what s/he only pretends is an uninvited and unintimated intimacy, or rather (as this pretending is not a conscious process, though s/he is, initially at least, conscious of it) the filmgoer comes to forget that this intimacy is the result of an economic arrangement. (Isn't this also the illusion fostered by pornography, and by prostitution for that matter?)

Kaja Silverman writes that "the level of enunciation remains veiled from the viewing subject's scrutiny, which is entirely absorbed within the level of the fiction; the subject of the speech seems to be the speaking subject […] the gaze which directs our look seems to belong to a fictional character rather than to the camera." (Silverman 1985: 202) This illusion or forgetting (this suspension of disbelief as it's sometimes called) is first of all forged by the technique the filmmaker employs to make an audience lose itself in the film – primarily, that is, by the technique of suspense, a technique of which Hitchcock, of course, remains the undisputed master.

The film of course is an exhibitionist, though it pretends not to be. Its affectedly coy striptease is made possible, technically, by its parallel illusions of secrecy and intimacy. Hitchcock, in conversation with François Truffaut, fantasizes the following scenario:

Something I wish I could work out is a love scene with two people on each side of the room. It's impossible, I suppose, because the only way to suggest love would

be to have them exposing themselves to each other, with the man opening his fly, and the girl lifting her skirt […]. I suppose that would come under the heading of out-and-out exhibitionism. (Truffaut 1985: 262)

It's not simply for reasons of moral censorship that this scene wouldn't work cinematically. It is, as Hitchcock says, quite literally 'out-and-out' – it fails to perform the tantalizing function which Roland Barthes (Barthes 1973) accounts so essentially erotic in his essay on striptease. The tease is after all as important as the strip, the concealment as exciting as the exposure. What cinema offers is the exact opposite of Hitchcock's fantasy – an 'in-and-in' voyeurism. Hitchcock's scenario is exhibitionist precisely because it's presented in long-shot, and at a distance. Cinema offers to include and to entwine its audience vicariously within an illusion of partial participation, erotic or otherwise, a tableau in which the audience is too close to see everything. It's exactly in these terms that Hitchcock frames the extended screen kiss between Ingrid Bergman and Cary Grant in *Notorious*: "The public was being given the great privilege of embracing Cary Grant and Ingrid Bergman together. It was a kind of temporary *ménage à trois*." (Truffaut 1985: 262)

Hitchcock offers the same kind of intimacy in violence as in romance. This he achieves again through the introduction of a subjective, close-up intimacy which purports to dissolve the distance between voyeur and object, and therefore conceals the selfconsciously exhibitionist nature of the medium. The filmmaker can't simulate this intimacy through the use of an objective long shot any more than a modern novelist can achieve the same effect with a classical-realist third-person narrative. As Hitchcock comments, "[t]he only way to do it is to get into the fight and make the public feel it." (Truffaut 1985: 265)

The cinema audience is not perhaps so very different from the schoolchildren in François Truffaut's film *Les Quatre Cents Coups* (1959). Truffaut's film is the tale of a schoolboy who cuts classes to visit the cinema and puppet shows, and who ends up – like the young Alfred Hitchcock in an anecdote he often told of his own father's sense of justice or humour – in a police cell. Truffaut's schoolchildren in *Les Quatre Cents Coups* fool around in class – indeed, they simulate noisy love-making – each time their teacher turns his back on them: apparently in the mistaken belief that in doing so the teacher has suddenly become unaware of his audience. This is, of course, a model of the fallacious perspective adopted by film voyeurs.

Truffaut's movie is set in a Paris filled with film theatres. It also features a kind of a fairground ride, a giant spinning drum or rotor, large enough to hold a quartet of

paying customers, and reminiscent of that early precursor to the cinematograph, the diorama. The drum is viewed from above by an inanely grinning audience, whom Truffaut films from the participants' points of view – that is, from the perspective of the performers. The message is simple enough: the watchers are themselves being watched.

Rear Window: don't look now

Stella [Thelma Ritter], James Stewart's long-suffering nurse in Hitchcock's *Rear Window* (1954), laments that modern Americans – cinema-goers and their kin – have become "a race of Peeping Toms." Indeed, Hitchcock himself describes the film's hero as "a real Peeping Tom." (Truffaut 1985: 216) This is an indictment which Hitchcock also extends to his public: he speaks of "Peeping Tom audiences" – and of how he "allow[s] the viewer to become a Peeping Tom." (Truffaut 1985: 266, 272)

James Stewart plays L.B. 'Jeff' Jeffries, an action photographer frustrated by injury into voyeurism. He is an obvious enough model for the filmmaker and the filmgoer. He sits, with his leg in plaster, at his apartment window and observes his neighbours through a pair of binoculars and a telephoto lens. Stella imagines Stewart will end up getting caught by the law, and will plead in his defense that he loves "his neighbours like a father." There's something both sinister and skewed in this quasi-Oedipal implication.

For Stewart cannot on this occasion assume the mantle of the godlike father. He's not the one who, invisibly, sees. Stewart's character in *Rear Window* may be named Jeffries but he's not in fact the terrible judge. The gaze of patriarchal authority – of Jacques Derrida's God who's all-seeing and always unseen (Derrida 1992: 33), of Michel Foucault's warder in Bentham's Panopticon (Foucault 1979: 201) – punishes those, who, like Oedipus and Orpheus, have presumed to see too much: it punishes them with blindness, with the loss of their vision (in Orpheus's case, of his final, haunting vision of the diminishing, vanishing Eurydice). It may be no coincidence that James Stewart here boasts a broken leg: like the swollen-footed Oedipus, he is an impeded man.

Stewart at the end of *Rear Window* attempts to save himself (or at least to defer the inevitable) by firing off his camera flash in the murderer's eyes. Thus, for a moment, he adopts the blinding gaze of the divine, but it's only for a moment. The

murderer, a man called Thorwald (whose name perhaps suggests a thunderous god unlikely to be put off for long by this improvised lightning), advances on his victim, and Stewart topples from his window – from his divine pinnacle. He survives the fall: his actual punishment is a second broken leg, a reminder and a doubling of the frustrating frailty that first led him so to overreach himself. Yet this fall anticipates his greater, fatal problem with heights in his next Hitchcockian outing, *Vertigo*.

Stewart's primary problem, here and in *Vertigo*, is his Oedipal delusion: his belief that he can take the patriarch's place, that he can successfully assume the position of the invisible voyeur on high. The irony of this illusion is underlined in *Vertigo* by Stewart's obvious unsuitability to such a lofty situation. As a detective, he quite simply lacks the privacy necessary to the pursuits of a private eye. This privacy or secrecy is, of course, one of the defining illusions of cinema. Its counterpart is, paradoxically, the illusion that the audience is *not* in fact invisible, that each observer is somehow caught up, visibly and physically, in the action.

Stella, in *Rear Window*, goes on to critique Stewart's moribund relationship with his girlfriend, Lisa Freemont [Grace Kelly], a relationship undermined by Stewart's capacity for morbid introspection. (The name 'Freemont' seems to emphasize Stewart's own comparative lack of emotional or physical freedom, as well as the relatively unmountainlike nature of his lofty perch.) Couples, Stella says, oughtn't to "sit around analysing each other like two specimens in a bottle." Her metaphor is revealing. Kelly and Stewart resemble a pair of bottled specimens who are so busy regarding each other that they fail to recognize that they're in fact specimens themselves, that they're the ones being watched. It's this delusion which puts both of them in danger in *Rear Window* – they seem to forget that the object of the gaze (in this case, the killer) can witness his witnesses. Hitchcock is scrupulous to remind his audience of this fact: he emphasizes the way in which Thorwald's spectacles mirror Stewart's binoculars. It's not until late on in the film, in an uncanny moment of revelation and reversal, that Stewart comes to realize that "this fellow knows he's being watched." It's this same delusion which in *Vertigo* makes Stewart neglect the fact that he might not be the detective (the unseen viewer, the critic) which he presumes himself to be, but might actually be the unwitting and constantly observed actor in someone else's play.

The ordinary citizen cannot usurp the role of Big Brother, for indeed that would be to trangress the patriarchal law upon which (a great deal more than) Hitchcock's universe is based. Even *Psycho*'s Norman Bates – who so famously peeps on Janet Leigh as she prepares to shower – is essentially and eventually being watched

himself, not only by the cinema audience, and by his pursuers, and indeed by the police officer (that Hitchcockian symbol of menacing authority) whose gaze finally guides the viewer to spy upon Bates in his police cell, but also by the mother who constantly watches him from inside. Mrs Bates is not in fact a mother at all, but a figure of the father – that is, of the law of the father – the traumatic voice of self-censorship and societal judgment which follows in the wake of the Oedipal crisis (which is also, for Bates, a voyeuristic crime, a coming-upon his mother with her lover): "They're probably watching me – well, let them, let them see what kind of a person I am […]. I hope they are watching […] they'll see."

Stewart's character in *Rear Window* is repeatedly accused of the kind of sociopathic behaviour for which Bates is later anathematized. Stella refers to his pair of binoculars as a "portable keyhole" – Kelly calls his voyeuristic hobby "diseased". For Stewart, as for Bates, these acts of voyeurism contain an inevitable sexual element – more so, they represent a sexual (an erotic and an emotional) substitute for the man whose broken leg at once symbolizes his impotence and his sexual frustration – it is, after all, suspended in a state of permanent rigidity.

When the murderous Thorwald discovers Grace Kelly in his apartment, he turns out the lights: his attack upon her is at once sexual (in the dark) and also doubly frustrating for Stewart who can no longer see what's going on. Thorwald has thus, by turning out the lights, usurped Stewart's place sexually, and at the same time denied him his erotic substitute, his voyeurism. Stewart sits there watching (but unable to see), in all ways impotent, his only phallus (a mocking substitute which not only points out his lack of a proper one but which also emphasizes the aching burden of his unfocused desire) the telephoto lens he cradles in his lap. This lack of a proper phallus (the symbol at once of power, of fullness, and of desire, of lack) is of course, as Lacan points out, a condition common to all men.

For Stewart, all the world's a studio. The windows to his neighbours' apartments are the shapes of film and TV screens; indeed some of his neighbours live, as he puts it, in "studio" flats. Yet the actors here appear aware they're being watched. A newly-wed husband draws his roller blind to maintain his nuptial privacy from Stewart's gaze; another neighbour draws her Venetian blinds in anticipation of a romantic interlude. Thorwald also seems to know he's being watched: "That's no ordinary look," says Stewart, "that's a kind of a look a man gives when he's afraid somebody might be watching him." It's in effect a theatrical look. When Kelly asks Stewart whether he honestly believes a real murderer would let anyone see all the suspicious things that Thorwald's let our hero see him doing, he answers that

the killer's apparent 'nonchalance' is a performance, a façade: "That's where he's being clever."

Yet still Stewart stubbornly refuses to see that he himself can be seen. When Thorwald returns the voyeur's gaze, Stewart tells Stella to get out of sight: "Get back. He'll see you." But Stella's no stranger to such attention: "I'm not shy. I've been looked at before."

Of course she has. Her name says it all. Stella – the star – that which presumes to look down from on high like an unseen god, but which is in fact visible to all, which is unendingly gazed upon. The film's real stars are of course Grace Kelly and James Stewart: and Hitchcock's irony is that they pretend to presume they can't be seen. Cinema's stars precisely and definitively lack this power: theirs is not the status of gods whose power lies within an omniscient, voyeuristic anonymity and invisibility, but of blind icons and idols. Stewart and Kelly symbolize the very nature of stardom; and nicely (if only coincidentally) their names combine to synthesize that quality's own name – Stewart, Kelly: they're really the ones who are *stellar*.

Vertigo: dizzying heights

Does the name of Gavin *Elster* in *Vertigo* (1958) similarly reveal his status as the *stellar* godlike manipulator and mastermind? Stewart's name in that film, 'Ferguson', obviously echoes his disorder, the eponymous *vertigo*, but mightn't it also suggest another name, the name perhaps of his character's mythic forebear – the similarly hell-bent Orpheus?

This is after all a story of, in the words of its screenwriter, Samuel Taylor, "a man losing a woman to death and then resurrecting her." (*Hitch: Alfred the Auteur*, BBC TV: 1999) The names in *Vertigo* are, incidentally, the invention of Hitchcock's film: they differ completely from the names in Pierre Boileau and Thomas Narcejac's 1956 novel, *The Living and the Dead*, on which *Vertigo* is based.

The relationship between Elster and Ferguson is shown from early on as being one in which questions of epistemological and physical superiority are controversial and ambiguous. When the pair first meet, the construction cranes which stand outside Elster's office appear almost to taunt the acrophobic Ferguson. Elster is filmed from below; his superiority is emphasized when he steps up onto a

little platform. He looks down upon the seated John Ferguson. However, when Ferguson stands we recognize he's significantly taller than Elster – as if the sense of superiority conferred by Elster's power and wealth is dwarfed by the moral high ground occupied by Ferguson, the invalided ex-policeman. Throughout the scene, Elster and Ferguson change positions: Stewart sits and Elster perches on the edge of a table; Stewart stands, leans against a desk and walks around, while Elster sits. The scene is blocked and shot like a parody of a corporate power game of psycho-physical superiority and subordination.

Again, as in *Rear Window*, the danger for James Stewart lies in his inability to recognize the precariousness and visual/vertical vulnerability of his own position. He begins to spy on (the woman he presumes to be) Elster's wife [Kim Novak]. He watches her for the first time in a restaurant, unaware that he's not seeing reality at all, but a performance staged for his own benefit – that he (like the cinema-goer) is in fact the unwitting focus of the events he observes, that his voyeurism is the reason for the events he witnesses.

When Stewart follows Novak into a flower shop, he watches her from behind a mirrored door. At this moment of ambiguity (of at once duality and fragmentation, when we see the pursuer alongside the mirror-image of the pursued, and we can no longer be entirely sure which is which), their roles are briefly reversed. He has followed her into the shop, but she follows him out. Hitchcock himself commented on the tension, suspense and ambiguity generated by showing the hunted and the hunter at the same time (usually achieved by cross-cutting, but here in *Vertigo* actually shown in the same shot): "the audience can run with the hare and hunt with the hounds." (Gottlieb 1995: 130) In so many of Hitchcock's movies – *The Man Who Knew Too Much* (1934 & 1956), *The Thirty-Nine Steps* (1935), *Saboteur* (1942), *Stage Fright* (1950), *Strangers on a Train (1951)*, *I Confess* (1952), *To Catch a Thief* (1955), *North by Northwest* (1959) – indeed perhaps in all his films – the protagonist is both the pursuer and the pursued.

Vertigo perpetuates and underlines these reversals. When Novak (for the second time) visits an art gallery, Stewart follows her in, but once more she follows him out. The following day he follows her car, as she drives to his own apartment. The pursuer has very much become the pursued, the viewer the viewed.

When Stewart follows Novak to a hotel, he, outside on the street, watches as she stands at the window of an upstairs room and removes her coat. Even though she's so obviously in the position of the observer (up above, looking down), her

stagecraft (her absent gaze, her undressing) perpetuates his illusion that he is indeed the voyeur. But when Stewart follows her into the hotel, another – rather stranger – reversal takes place. The hotel's proprietor informs Stewart that the woman is not in her room; Stewart goes upstairs to find the room empty. He looks out of the window – thus assuming her position, exchanging roles again – but Novak and her car have gone from the street from which he, a few moments earlier, had presumed he'd been watching her.

There's no explanation given for this scene. It doesn't make a lot of sense in terms of Elster's plot, or of Hitchcock's for that matter; it function seems to be wholly symbolic, to underline the scopic ambiguities and reversals on which the film is based. It seems a cheap trick that Novak has played on Stewart. It's as if Orpheus had been set up by Eurydice. It was all a practical joke. He follows her to hell, but, when he looks down, she's not there. Stewart's half-wilful failure here to recognize Novak's duplicity emphasizes the frailty of the voyeur's (like the sadist's) self-delusion: he does his best to ignore the possibility that his object might be doing it on purpose – and might be *enjoying it*.

Stewart's vertigo is that of an Orpheus who has, by the end of the film, had to watch three times as others (once a fellow police officer, and twice, the woman – the same woman – he loves) have fallen from him into the world of the dead. Ovid's version of the myth is worth recalling here: "the lover looked behind him, and straightway Eurydice slipped back into the depths. Orpheus stretched out his arms, straining to clasp her […] but the hapless man touched nothing but yielding air […]. At his wife's second death, Orpheus was completely stunned." (Ovid 1955: 226)

Isn't this precisely the state in which Stewart finds himself at the end of Hitchcock's film? Novak is a Eurydice who keeps coming back from the dead only to taunt Orpheus once again. Novak returns three times from death: first as the spirit of Carlotta Valdes who appears to possess the body of Madeleine Elster; then when Stewart saves her life when she pretends to attempt to drown herself; and finally as Judy Barton, the woman who looks the spitting image of the deceased Mrs Elster (but only because she is her).

Stewart is an exhausted, defeated, cheated Orpheus. He discovers the story of Carlotta Valdes at an antiquarian bookshop, whose name, the *Argosy* bookstore, reminds us no doubt that Orpheus himself was one of Jason's Argonauts. Novak enacts the role of Elster's wife, Madeleine, but remains an unsaved Magdalene (unsaved because Stewart is a failed Orpheus, not a resurrecting Christ); and,

echoing the fate of the much-abused Carlotta Valdes, she's soon to become Elster's discarded whore.

In his interview with François Truffaut, Hitchcock launches into an appropriately whorish anecdote about some research on the subject of belly dancing he conducted during the making of his 1932 film, *Rich and Strange*:

A.H. The reason I was interested in the belly dancing is that I wanted to show the heroine looking at a navel that goes round and round and finally dissolves into a spirallike spinning motion.

F.T. Like the main title of *Vertigo*?

A.H. Yes, that's it. In *Rich and Strange* there was a scene in which the young man is swimming with a girl and she stands with her legs astride, saying to him, "I bet you can't swim between my legs." […] The boy dives, and when he's about to pass between her legs, she suddenly locks his head between her legs and you see the bubbles rising from his mouth. Finally, she releases him, and as he comes up gasping for air, he sputters out, "You almost killed me that time," and she answers, "Wouldn't that have been a beautiful death?" (Truffaut 1985: 81)

The provenance of the title of Hitchcock's film – from Ariel's description of a drowned man in *The Tempest* (I, ii) – would appear to underline the significance of this subaquatic adventure, this suffocating, phobic tale of an innocent caught in the space between a woman's legs. This scenario has been dredged from the depths of the director's memory or imagination by talk of spiralling navels, the threatening, irresistible spaces of generation. Hitchcock's stream of imaginary associations of sex and death, witnessed in his vertiginous perspective upon the eye, navel and vagina, begins to explain the sequence of optical spirals which recur through his films.

That falling feeling, the onset of vertigo and of *Vertigo*, it's all in the eyes: in those subjective shots of staircases and streets as seen from above, through John Ferguson's elasticated gaze. Hitchcock's film opens with an extreme close-up of the bottom right quarter of a woman's face, focuses in on the mouth, moves up to the nose and eyes, and finally closes in on the left eye. The screen turns red, as the eye flares orgasmically open, suggesting a connection between sex and death which the film and its plotters will exploit. The eye then fades into a series of vertiginous twisting and spiral forms, like galaxies out of the angst-ridden nightmares of an existential cosmoloist.

The source of James Stewart's fascination with Kim Novak in this film is, according to Tania Modleski, "her own fascination with death, with the gaping abyss" (Modleski 1989: 91) – but isn't it also *his* (and Hitchcock's) own fascination with her *as* death (and as birth too, for that matter), with her as the gaping abyss, with the female body's own gaping abyss of birth and erotic oblivion?

This isn't a version of *vagina dentata* so much as an echo of the sado-erotic climax to Georges Bataille's *Story of the Eye* (Bataille 2001) – when the eye of a murdered priest is placed in the vagina of the heroine. For Hitchcock the horror lies in the possibility of being seen by this third unseeing eye, by de Sade's all-encompassing 'eye of God', which is also the eye of the mother who, like Mrs Bates, watches us from birth till death.

Psycho: entre deux morts

Hitchcock most famously melds these vertiginous patterns into an image of an eye as the bloody water spiralling menstrually down the plughole in *Psycho* segues into the shot of Janet Leigh's dead eye staring straight into the camera, and Hitchcock's camera (the artist's own eye) itself spirals out from the artiste's eye to reveal her naked corpse on the bathroom floor.

He tries something similar, but to much less effect, in *Frenzy* (1972), when the strangulation of Brenda Blaney [Barbara Leigh-Hunt] is depicted through an extreme close-up of her popping eyes staring accusingly into the camera. This then cuts to a medium shot of her corpse, the tongue lolling from her mouth, her eyes still staring into the director's lens and the viewers' gaze. The staccato – frenzied – style of *Frenzy*'s editing and direction lacks the vertiginous, stomach-and-eye-twisting nausea of the celebrated *Psycho* shot (a shot which achieves its deathly calm from the contrast it presents to the stabbing cuts that have immediately preceded it). This killing in *Frenzy* more closely resembles the clinical, faceless, inhuman horror of the disfigured (and significantly eyeless) cadaver discovered in the farmhouse in *The Birds* (1963), when the camera's perspective again adopts, as it closes in on the corpse, a "staccato movement" (Gottlieb 1995: 300-1).

The eye in *Psycho* (1960) – more haunting, more disturbing, than Norman's at his peephole – is the dead eye of what one might describe (in the dregs of Estuary English) as a 'stuffed bird': the eye of Marian Crane. Like Clarice Starling in *Silence of the Lambs* (1991), the psycho's plaything is named after a creature of the air. The

eyes of Norman Bates's previous victims, his taxidermised birds, have already glared down in silent warning at Janet Leigh, but she has ignored their gaze.

The victims stare with lifeless eyes, but so do the murderers themselves – for Bates and Thorwald are voyeurs as impotent as Ferguson and Jeffries. The voice of Bates's mother, ringing in his head at the end of *Psycho*, posits itself as the innocent victim of her son's crimes (which of course she is; she was after all his first victim), as passive a spectator as any cinemagoer: "as if I could do anything except just sit and stare, like one of his stuffed birds."

Bates has, of course, stuffed his own mother, so to speak, in a style that might have made Oedipus blush. Yet who here really is the stuffed one, the hollow one? Although we're expected at first to recognize the irony that it's not the mother but Bates himself who's the stuffed puppet – that it's she who looks out through his soulless, staring eyes – it isn't of course Bates's mother's voice inside his head, but his own Oedipal internalization of his mother, an obsessional, melancholic and therefore (as Freud would say) narcissistic impersonation, an expression eventually of his own self-loathing desire.

His mother's eyes can do no more than stare because, in her mummified cadaver, they're in fact no longer there. Their empty sockets offer up a remorseless gaze that can never be averted, one that can never be imagined as looking away. The gaze is not a sign of vitality or activity, but of loss, of the fall into death. The eye of the camera, in all its glorious psychosis, can offer nothing more than the perspective of Orpheus upon the descent of Eurydice, the descent back into that great chasm of birth and death, at one and the same time vagina and grave. Hitchcock's notorious misogyny and his infamous fear of authority converge upon this descent, this fall from integral selfhood into the morbid eroticism which represents at once the transgression of the law of the father and the punishment for that transgression.

Hitchcock's *Psycho* is sited in what Slavoj Zizek calls the "place 'between the two deaths'" (Zizek 1989: 135) – "the blemished domain between two deaths" (Zizek 1994: 2) – between the actual death of Bates's mother and her symbolic death enacted in the killing of his victims; just as *Vertigo* takes place between the death of the real Madeleine Elster and the death of her substitute. This realm is, according to Zizek, "a place of […] terrifying monsters […] the site of *das Ding*." (Zizek 1989: 135) "There is [writes Slavoj Zizek] in [the symbolic order's] kernel, at its very center, some strange, traumatic element which cannot be symbolized, integrated into the symbolic order – the Thing." (Zizek 1989: 132)

The scene in *Psycho* involving the murder of the private detective Arbogast involves the viewer in a sequence of disorienting identifications which lead towards this Freudian Thing. The subjective perspective of the detective (as he climbs the stairs to his death) is juxtaposed with a shot from above the stairwell, which then cuts to the viewpoint of the killer, the unbearably monstrous Other, as we watch our victim fall – from the simultaneous perspectives of the monster and the victim, of the hunter and the hunted, of Orpheus and Eurydice.

Slavoj Zizek writes of the scene of Arbogast's death:
The inherent dynamic of the entire scene of Arbogast's murder epitomizes *Psycho*'s trajectory from hysteria to perversion: hysteria is defined by the identification of the subject's desire with the desire of the other (in this case, of the viewer's desire with the inquisitive desire of Arbogast as diegetic personality); whereas perversion involves an identification with the 'impossible' gaze of the object-Thing itself – when the knife cuts Arbogast's face, we see it through the very eyes of the 'impossible' murderous Thing. (Zizek 1992: 249)

We, the viewers or voyeurs, are caught here within what Zizek terms "a complicity between 'absolute Otherness', epitomized by the Other's gaze into the camera, and the viewer's look." (Zizek 1992: 244) We become at once what we most desire and what we most dread (desiring): the lost and always searched-for object of Oedipal desire, the (M)other.

The desire for the mother is as impossible and as urgent as the desire for the return of the dead. Yet what happens to those, like Norman Bates, who have satisfied this desire, or at least an uncanny simulacrum of it? What happens to those who have shattered the laws of patriarchy, who have killed the father, who have inhabited the body of the mother (and vice versa), and have brought her back from the dead – and yet who at the same time, because this crime is impossible, have not done so, cannot have done so, and cannot therefore return either to the body of the mother or to the symbolic order of patriarchy? Or, as Hitchcock, while outlining a prospective scenario to Francois Truffaut, asks: "If the dead were to come back, what would you do with them?" (Truffaut 1985: 309)

Norman Bates has murdered not only his mother's lover (his *symbolic* father) but also his mother, whose identity he is then obliged to assume in order to disguise (to himself) his transgression. His double crime (at once Oedipal and anti-Oedipal), his double bind, prevents his redemption by, or reintegration into, either the imaginary realm or the symbolic order. Yet, as Hitchcock suggests, by letting (by *forcing*) the

audience to assume the position of the monstrous gaze, his precarious and perilous situation is one we all share: a state of being between two myths (those of Orpheus and Oedipus), between two orders (imaginary anarchy and symbolic patriarchy), between two lives and therefore two deaths – which in the end, and from the very beginning, have always been radically different and inherently the same.

Conclusion: Medusa laughs last

Much has been written of the filmic gaze, much of it in reference to (and in suspicion of) Alfred Hitchcock. Most famously, Laura Mulvey has seen the male gaze in cinema as a fetishization and objectification of the female Other. Feminist film criticism itself has, however, tended to objectify this voyeuristic gaze as an unequivocal, unambiguous and therefore intrinsically unproblematic symptom or symbol of patriarchal sadism – while at the same time viewing Hitchcock and his ilk as the unreconstructed protagonists and advocates of that misogynistic gaze.

Yet Hitchcock is not Norman Bates, nor is he Jeffries nor Ferguson. Like Stanley Kubrick in *Eyes Wide Shut*, Hitchcock remorselessly and remorsefully excavates the masochistic terrors which underlie the sadist's pleasures. Hitchcock, like Lacan, understands that desire is itself a fetishization: a sign of lack and a substitute for what is lacking – for the desire for that object whose desire cannot be borne, that unnamable thing… not the sadistic, phallic basilisk (half-snake, half-cock, a voyeur which can kill you with a single look), but the Gorgon, the transcendentally female exhibitionist who'll kill you if you look at her/it.

Traditional psychoanalytic film criticism – like traditional psychoanalysis – seeks answers: yet, try as some critics might, we cannot fruitfully analyse Hitchcock in this way, because he has already performed this analysis himself, and has found that it leads nowhere. As Slavoj Zizek does, perhaps the best that we can do is to strain (our eyes) to watch Hitchcock as he explores the darkness – and to acknowledge that this is a darkness which we must recognize and even penetrate, but upon which we can cast no light.

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