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A study of the factors influencing FDI for small and medium enterprises in Macedonia

Abstract

This research paper explores the factors influencing FDI for small and medium enterprises in Macedonia and their impact on economic growth and business development in the country. It examines the challenges that Macedonia, a newly independent nation, faces in the economic, political and legal arenas.

As the world economy becomes increasingly integrated, it is important to track the emergence of new havens for business innovation and capital inflows. Macedonia is undertaking a dramatic transformation from a legacy Communist system of government to a market-based, competitive system which goal is to attract foreign direct investment and entrepreneurial talent within its borders.

A thorough review of the steps the government of Macedonia is taking to advance the country's competitiveness in the region is followed by an assessment of what the political, economic and legal transformations mean for small and medium enterprises. The reforms that the Macedonian government is undertaking are of great importance for the successful process of transformation and privatization. The paper reviews the legacy business culture, the modes of entry for small and medium enterprises, and the web of trade agreements Macedonia is engaged in. These reforms will contribute directly to the development and growth of the Macedonian economy.

Keywords: Macedonia, FDI.

Introduction

In Europe, there are many countries with strong historical associations but no one can be compared to Macedonia. It is a tribute to the persistence of the people that the ancient Macedonian name has survived for over two thousand years, long after the nation ceased to play any important part in European history. Macedonia is located in South-Eastern Europe, and has a central position on the Balkan Peninsula. It is a small country of natural beauty, with a population of 2.1 million and a total area of 26.000 sq.km. Its main ethnic groups are Macedonians (64%), Albanians (25%), and others (11%). The primary religion is Orthodox Christian, with 65% membership. One out of every three Macedonians embraces the Muslim faith (Macedonian Investor's Manual, 2007). Macedonia declared its independence on September, 8, 1991, after the break-up of the former Yugoslavia. It is the only member of the former Yugoslav Republic that gained its independence peacefully. In the turbulent times that followed, marked by wars and economic turmoil in the region, Macedonia kept its political stability and remained on the path of profound economic and social reforms.

"Immediately following the establishment of a multi-party parliamentary political system and attaining independence, the people and all political parties in the Republic of Macedonia embraced the European orientation, with a permanent view towards the free Western world and America. Awareness has prevailed in Macedonia for the need to create an economically viable country with high standards of living and a strong inclination to abide by the international democratic norms firmly asserted in Macedonia's Constitution and laws. Macedonia had certain advantages that enabled the country to pass through the period of transition much easier than other Eastern European countries. The democratic processes in Macedonia were much more advanced and more liberal than those in the East, especially in the area of the economy.

Accepting a market and liberal economy in Macedonia was not a major shock as it was in the East. Just the opposite, Macedonian citizens readily awaited such changes, because the prevalent understanding from the past was that such an economic system was more advanced and more just. Macedonia was ready for transition, because in 40 years, it had adopted many elements of a market economy, where profit was a main goal and private ownership was not a taboo" (http://faq.macedonia.org).

1. Transition

Improved company performance is at the heart of any successful transition from a command to a market-oriented economy. The standard pattern in the transition economies has been to seek improved companies by heightening competition and sharpening corporate governance in various ways. For example, this has been achieved partly through the privatization of state-owned firms and by allowing and encouraging new firms and competition among existing firms and the withdrawal of government subsidies. Companies are responsible for their "bottom line", referred to in this literature as a "hard budget constraint" (Lovren M., 2003).

Since the beginning of 1993, the Macedonian government has implemented a bold program to restore macroeconomic stability and support a rapid transition towards a market economy. Intermittent conflicts and disturbances have had an adverse impact on the development of the institutions necessary to support transition. The reform strategy has been designed around the discipline of fixed exchange rates coupled with other structural reforms. The goal has been to create market institutions, consolidate private ownership, and reduce the cost of doing business. Financial support from the International Monetary Fund, the World Bank, European Union, and other bilateral donors has been key to the successful implementation of the program (International Monetary Fund, November, 2003).

Since the onset of the process of economic transition in Macedonia, two basic views have existed with regard to the time needed for this process. Those who advocated shock therapy, or fast change, believed the transition, in its initial phase, will cause increased unemployment and a reduction of the social and economic security of the citizens, but also believed that, by strengthening the private sector, the unemployment will begin to drop while the social and economic security of the people will begin to grow. As a response to the expected social costs of higher unemployment, the creation of a minimal social fund was suggested. On the other hand, the followers of the gradual approach, or slower change, indicated that the shock therapy will cause mass long-term unemployment with huge consequences for the standard of living of the citizens. In this context, they paid special attention to the possible pressure on the budget of the country with respect to social security requirements for the unemployment (Commission of the European Communities, Brussels, 2004). The Macedonian government took various measures to manage the economy and to benefit private initiative, not long after achieving independence from the Republic of Yugoslavia, in spite of the difficult internal and external situation.

2. Privatization

Transformation of ownership was recognized as crucial for the transition towards a free market economy. Privatization became a priority to the newly independent state. Privatization in Macedonia was initially introduced in 1989 with the Law on Social Capital of the Former Yugoslav Federation. At that time, the government of Prime Minister Ante Markovic introduced the concept of privatization through which internal shares were issued to all employees of the socially owned enterprises (SOE's). In the process, over 600 enterprises in Macedonia were transformed into joint stock companies or limited liability companies (Journal of Economic Perspective, 2002). A real boost to the process of privatization was given by the enactment of the new Law on Transformation of Enterprises with Social Capital in June 1993 (Djankov and Murrell, 2002).

The results of the previous privatization with internal shares were generally being recognized, but only after a prior audit of official supervisory institutions, authorized by the new law to control the privatization transactions made by the previous law. The Macedonian enterprises in the previous-socialist economic system were not owned by the state, like in other communist countries. The equity belonged to "everybody and nobody", i.e. to all society, and was called "social capital".

The enterprises were ruled by the workers' councils which played the role of owners, and management had a fair degree of authority for acting independently in the business environment. The market wasn't fully restricted, as it was the case with the central planning in the other communist countries (Bennett, 2001). All that contributed to the development of entrepreneurial spirit and managerial skills. One of the most important steps taken by the Macedonian government towards a free market economy was the privatization of the public firms, developed by the Privatization Agency of the Republic of Macedonia; this is the key institution responsible for the administration and support of the privatization program. Its goal was to offer for sale the available public capital, in an open auction through the Macedonian Stock Exchange.

The year 1996 ushered in the privatization of the agricultural sector, including approximately 350 companies. In 1997, the scope of the privatization program expanded to include the companies operating in the insurance sector and companies that organize games of chance, or altogether approximately 1,600 legal entities. By the end of 2002, 1,688 public-capital companies have been privatized, including the three main banks (Government, 2003). The priority task of The Macedonian Agency was to accelerate the privatization. The documents which had to be submitted to the Agency, along with the Decision for Transformation, include: the valuation of the enterprise, the program on the proposed method of privatization, the report on the audit of the implementation of the Law on Social Capital, the court registration and evidence of ownership rights on the real estate of the enterprises.

The Macedonian privatization process looked something like this:

- 30% of the social capital (in a form of ordinary shares and stocks) is offered to the employees, under privileged purchasing terms (certain substitution to the voucher model);
- 15% of the social capital (in a form of ordinary shares or stocks) is automatically transferred,

(free of charge) to the State Pension Fund. The Fund may, on a basis of an autonomous decision, sell those shares;

- 55% of the appraised value of the enterprise is available for sale as ordinary shares or stocks, under equal conditions both for domestic and foreign investors. Employees are offered a generous discount scheme. They have an initial discount of 30% plus 1% for each year of work in the enterprise. Employees can buy shares at a discount of up to an amount not higher than $25.00 in five-year installments without a down payment and with a two-year period (World Bank Economic Review, 2001).

3. Investment climate in Macedonia

"Foreign direct investment has been identified as a crucial component for supporting the transitional process of the Macedonian economy, and one of the objectives of privatization – to increase the efficiency of the newly privatized enterprises, was to be achieved through the attraction of foreign capital in privatization. The inflow of foreign investment through privatization has started modestly. The reasons for this may be grouped in two segments.

The privatization program in Macedonia is taking place under unfavorable circumstances. In a political sense, Macedonia is relatively unknown to foreign investors. In the past, it has been identified mainly with the war-torn republics of the former Yugoslavia. In this period, a number of other countries in transition were fiercely competing to absorb the available foreign capital (World Bank, 2000).

Macedonia did not have a distinguished, recognizable campaign for attracting foreign investments. Investment promotion activities intensified in 1997, after the risk factors associated with the country were substantially diminished. As a result, most of the privatizing companies were bought by Macedonian residents, particularly by the former employees of such companies" (World Bank, 2000).

Macedonia today, is undertaking substantial reforms in its economic, legal, and political systems, which should improve its attractiveness to foreign investors.

In December 2005, the European Union granted Macedonia candidate status. "Macedonia made significant legal reforms to attain candidate status, and will have to implement substantial additional reforms to meet the requirements for EU membership.

Implementation of the internationally mediated Framework Agreement (FWA), which ended the 2001 civil conflict between ethnic Albanians and the Government, was completed in 2005, and Macedonia's political and security situation is stable. The World Bank and the International Monetary Fund (IMF) signed agreements with the government for a three-year program in 2005. The World Bank program includes numerous administrative reforms of the Government bureaucracy to improve the business climate.

Macedonia has achieved macroeconomic stability. Inflation is low (1.5% estimated for 2005), the Government budget deficits are targeted to be only 0.6% of GDP, the currency is stable and pegged to the euro, and economic growth was an average of 4% between 2003 and 2006" (http://europeanhouse.blogspot.com). For 2007-2008, economic growth averaged 5% (The CIA World Factbook).

Macedonia is relatively open to international trade; with total 2007 trade (imports plus exports of goods and services) reaching $6 billion (PriceWaterhouseCoopers – Guide to Doing Business and Investing in Macedonia, 2008). Macedonia's major trading partners are Russia, Germany, Greece, Serbia and Montenegro. In 2004, US-Macedonia trade in goods totaled $119.8 million. US meat, mainly poultry, and electric machinery have been particularly attractive to Macedonian importers. Principal Macedonian exports to the United States are tobacco, apparel, footwear, iron and steel (UNDP, 2005).

As specified by the Company Law, the following forms of business can be established in Macedonia: general partnership, limited partnership, Limited Liability Company, joint-stock company, and limited partnership by shares. "As of January 2006, the "one-stop-shop" system for registering business activities has started, operated by the Central Registry. This is allowing registration within 5 days, eliminating the previous long, bureaucratic registration process" (Government-Privatization Agency, 2005).

4. Entry modes

Macedonia's retail sector is dominated by small shops. Retail outlets vary from road side shops and open air markets to city storefronts and shopping centers. The main shopping mall in Skopje stood half-empty only a decade ago. Now, it is teeming with merchandize and shops. Many of the shops carry Western goods. Some Western outlets have also opened in Skopje. Consumer-oriented trade shows are an important part of the retail scene. Frequent sector-specific shows such as food and consumer electronics shows attract regional and local exhibitors.

Franchising of US and Western European companies are still uncommon in Macedonia. There are now several franchises operating in Skopje. McDonald's opened three successful restaurants in Skopje between 1997 and 1999. Holiday Inn opened in 2002. Radisson SAS Hotels and Resorts has signed an agreement to manage its first hotel in Macedonia. Although franchising is a new concept for the business community in Macedonia, the legal system in Macedonia accommodates franchise agreements, and in 2003 the Macedonia Franchise Association was established to help domestic and foreign companies (Utrinski Vesnik, 25 Feb. 2006).

"Existing legislation permits joint ventures, mixed ownership investment, and both foreign and domestic investments. Many large firms are undergoing privatization and joint ventures are becoming more common. Since Macedonia is a small market, there is no major distribution or warehousing operations. Efforts to establish free-trade zones to serve a larger Balkan market have not yet materialized. Market size statistics are unreliable in predicting market responses. While low official disposable income statistics might initially discourage market entry, the size of the unofficial economy and inferences from observation of actual sales activity paint a brighter picture. First-hand observation on the streets and in the shops is essential for gauging the amount of actual economic activity in Macedonia" (http://macedonia.usembassy.gov). Advertising is one of the fast-growing industries in the country, despite the fact that the concept of advertising is relatively new there. Both consumers and companies are beginning to understand the effectiveness of advertising and the importance of marketing products.

5. Small and medium enterprises in Macedonia

Macedonia is a small and relatively new market so it needs investment from foreign and domestic investors, especially in small and medium enterprises. In 1996, when the privatization process started in Macedonia, in the first year alone, over 50,000 private businesses were opened, with few employees and most often in the area of trade. Today SMEs have 5-100 employees and 60% of the total workforce is employed in SMEs with a total of 40.000 SMEs in the country (Government, 2006). Macedonian citizens and foreign nationals are subject to Macedonian law. By law, employment contracts consist of: description of the employee's duty, duration of the contract and termination date.

The Government Program for Stimulating Investments in Macedonia is outlining the following reform priorities (Government, 2006):

- creation of the detailed Action Plan to reduce barriers to investment;
- creation of the Foreign Investment Agency.

The Foreign Investment Agency of the Republic of Macedonia will focus on:

- image building and promotion portraying Macedonia as an attractive site for investment;
- investment generation;
- proposing measures for the improvement of the investment policy and amendments to the respective legislation;
- servicing investors;
- intensification of the fight against corruption, bribery and favoritism;
- reform of the tax system and associated investment incentives (News, 2006).

With the aim of enabling the environment for private sector and investments, the Ministry of Economy has undertaken these measures:

- implemented the strategy for the finalization of the privatization process through the Macedonian Stock Exchange;
- improved transparency in the process of issuing licenses for exporters through the introduction of the "first come, first served" principle, an important development in the attempt to reduce corruption;
- initiated a program for the development of small and medium sized enterprises, including a new implementation agency, designed to stimulate start-ups and early growth companies (Milica G., 2005).

"There are no legal barriers to the free flow of financial resources and portfolio investments. Financial resources are almost entirely managed through the Macedonian banking system. At the end of the first half of 2005, foreign investors owned roughly 52% of the total banking assets, and foreign capital was present in 16 out of a total of 20 banks. According to the Central Bank date, at the end of June 2005, the percentage of the non-performing loans in the total credit portfolio was 11.8% (National Bank of Republic of Macedonia, 2006). Domestic companies are financed primary from cash flow, due to lack of corporate bonds or securities as alternative credit instruments. Macedonia's securities markets are limited in turnover and capitalization.

The establishment of the Stock Exchange in 1995 made it possible for portfolio investments to be regulated. On March 28, 1996, the commencement of trading operations created a central marketplace for securities trading. This was also the first organized stock exchange in the history of the country. Until recently, activity on the stock market was extremely limited, but the offer of shares from well-established companies in 2005 attracted both domestic and foreign investors.

The Securities and Exchange Commission adopted legislation that regulates Macedonia's securities market" (US State Department, Yearly Bulletin, 2005).

"Macedonia has no regulatory defence measures directed against foreign investment. Similarly, there are no private or governmental measures directed against foreign entities to block them from investment, participation, or control of domestic enterprises, or industrial organization. With the inflow of international aid, experts and projects, Macedonia is in process of harmonizing its legal and regulatory systems with international standards" (Richard F., 2006).

6. Problems Macedonia is facing today

Macedonia, as a new country, has major problems attracting FDI, problems that limit the development and growth of Small and Medium Enterprises. Double taxation and a banking system that is still not stable figure prominently in the list of obstacles. Everyday, the administrative rules are changing, and corruption still permeates through society.

"After the fall of communism, Macedonia inherited a government system rife with corruption. By establishing an Anticorruption Commission, the government made a commitment to combat corruption and bribery in public administration, focusing also on senior-level officials. A series of laws have been drafted and amended to control vices ranging from drug abuse to money laundering, and to create a legal firewall against corrupt practices. In addition to the Laws on Criminal Procedure that criminalize acts of bribery, illegal mediation and the abuse of the official position, two major laws for combating corruption were adopted in 2002: the Law on Money Laundering Prevention, establishing a directorate to monitor and report money laundering, and the Law on Corruption Prevention, which provides jail terms of up to 10 years for corruption of illegally obtained property" (Private FDI Information, 2006).

7. The needs of SMEs in Macedonia

In the legal and regulatory systems:

- ♦ clear, consistent and appropriate business legislation;
- ♦ access to competitive prices and competitive markets;
- ♦ access to efficient and fair judicial system;
- ♦ reasonable taxation;
- ♦ registration and licensing, and other permits.

Security and crime control:
- ♦ secure environment for firms;
- ♦ compliance with the law.

Infrastructure:

- ♦ water and power;
- ♦ transportation;
- ♦ IT and telecom.

Loans:

- ♦ Access to adequate short-term loans to finance stocks and receivables;
- ♦ long-term loans;
- ♦ expedient loan processing (including credit rating agencies);
- ♦ appropriate collateral requirements (World Bank, 2004).

Macedonia needs foreign funds to help attracting foreign investment. One of the funds that help attract FDI in Macedonia is IFC. "Macedonia became a member of IFC in 1993. Since then, the country has received commitments of over $93 million in IFC funds and more than $25 million in syndications. IFC has invested in the textile, pharmaceutical, telecommunications, glass-machine production, steel, tourism, and financial sectors" (http://ifcln1.ifc.org). To support small businesses, IFC has invested in three financial institutions, including a line of credit to a local bank for lending to SMEs, as well as specialized financial institutions that provide credit and other financial services on commercial terms to SMEs in Macedonia. IFC will continue to support SMEs and micro-enterprises, post-privatized export-oriented companies, and the infrastructure sector (IFC, 2005).

SEAF (Small Enterprises Assistance Fund) is a small venture capital fund based in Washington, DC. SEAF investments are made in combination management training and technical assistance. This capital fund is actively engaged in implementing business strategy and involving up with advice rendered by outside experts. Macedonia needs this because the education level of students between 15-24 years old is 98.7% and there is not enough practice and modern technology for the young people to improve themselves (SEAF; Richard F., 2006).

8. Trade agreements

Macedonia is included in two trade agreements, one is in the regional market and the other one is in the European Market. Western Balkan Trade includes Macedonia, Serbia, Bosnia, Croatia, and Albania in the regional market.

Macedonia is a member of CEFT (Central European Free Trade Agreement) together with Bulgaria, Romania, and Croatia. By the end of 2006, CEFTA will be extended with the inclusion of Albania, Bosnia, Herzegovina, and Moldova. The new CEFTA will cover the original trade in goods and services, protection of intellectual property, competition and public procurement (CEFTA, 2006).

"Special tariffs apply to countries that Macedonia has signed a Free Trade Agreement with. In 2005, tariffs ranged from 0-30%, with an average rate on agricultural products of 18.02% and on industrial products of 7.66%. The only category to which a maximum rate of 60% is levied is cigarettes, while the rates on fruit and vegetables, cereals, alcoholic and non-alcoholic beverages have decreased from the maximum rate. The average rate for all products decreased to 10.05% in 2005 due to the reduction of tariffs on over 4.000 raw materials. In accordance with WTO regulations, further reduction of tariffs was expected by the end of 2006, and the average rate will drop to 9.49%. Excise taxes apply to wine, beer, coffee, cigarettes, tobacco, and vehicles. From 2004, new custom tariffs of 8% on European and US automobiles, and 10% on Japanese automobiles have been applied" (WTO, 2005).

According to the WTO, a number of products are subject to quality control inspection by market inspection officials at custom offices. These officials are employed by the Ministry of Economy to ensure that imported goods are in compliance with domestic standards.

An importer/exporter in Macedonia is responsible for providing the required import/export documentation, which consists of common trade, transport and custom documentation, as well as a certificate of origin and certificate of quality control and licenses.

Conclusion

Going forward, Macedonia continues to be very aggressive in its efforts to attract FDI. Some of the fiscal and monetary policies include:

- 10% corporate and personal income taxes;
- macroeconomic stability – low inflation and stable currency;
- high economic growth rate;
- export growth rate of 40% in 2007 and 28% in the 1st half of 2008.

The Macedonian government is offering incentives for investment in the Technological Industrial Development Zones. They include:

- 0% corporate tax for the first 10 years (10% thereafter);
- 5% personal income tax for the first 5 years (10% thereafter);
- no VAT and customs duties;
- subsidy of up to €500,000 towards building costs;
- land lease for up to 99 years at attractive concession rates;
- free connection to utilities;
- green customs channel, expediting exports to the EU;
- advantageous location – access to pan-European corridors 8 and 10, railroad and international airport.

The government of Macedonia has an education program geared towards business. This includes:

- elementary and high school education is mandatory;
- 85% of high school graduates are enrolled at universities;
- 6% of GDP is spent on education (Invest in Macedonia).

This study examined the development and growth of the Macedonian small and medium enterprises and their importance for Macedonia's future EU integration and stability. Macedonia, as an integral part of the Balkans, has already started to live with the European spirit. Macedonia is no longer a destabilization factor in the region. On the contrary, it is a successful exporter of regional stability. Macedonia has shown a sufficient vitality in the achievement of the important criteria for EU integration.

The beginning of 2007 marked a revival of industrial production, after years of stagnation. There are signs of growth in output and growth of exports, which is the main orientation of the Macedonian economy.

The advantage of the Macedonian economy is the exchange rate of the domestic currency. Hard currency is stable, inflation is small, labor is not costly and the state stimulates foreign investment and provides benefits for investors. From a geographical perspective, "Macedonia is the ideal place on the Balkan Peninsula for opening industrial capacities, for branch offices and consignment facilities that would gravitate towards a market of 30 to 40 million consumers" (http://faq.macedonia.org).

Albeit starting with a small base, the Macedonian economy holds the promise of growth and future prosperity in a long-neglected corner of Europe.

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