COMPARISON OF THE OLD AND NEW POLICY ON SUPPORTING INVESTMENT IN THE REPUBLIC OF NORTH MACEDONIA

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Abstract: *In 2017 the authors of this paper created a Vector Error Correction Model to measure the impact of the Technological Development Industrial Zones (TDIZ) on attracting FDI in the country. TDIZ, as an exemption of the regular customs territory, enjoyed preferential treatment for foreign investors. The model confirmed the positive effect that TDIZ had upon the balance of payments; however, the expected effect upon diminishing the high unemployment rate in the country was lacking. This paper is going to compare the latest revision of the policy on investment support in the country with the previous one.*

Keywords: *FDI, Technological Development Industrial Zones (TDIZ), incentives for foreign investors, investment policy, Vector Error Correction Model, the Republic of North Macedonia.*

1.   INTRODUCTION

In the last two decades the Western Balkan countries have been preoccupied with the issue of attracting foreign direct investment (FDI). Despite the creation of CEFTA-2006 and the latest effort to upgrade the free trade area into a regional economic area, the regional approach on attracting FDI seems to be difficult to be put in practice. There are many reasons for the dis-functionality of the area among which the most important seems to be the lack of political will. Countries within the region compete among themselves in offering foreign investors different sets of incentives and abundant state support in order to attract their interest.

The Republic of North Macedonia is not an exemption from the rule in the region. In the last 20 years the country made a lot of effort to create a favorable business environment for FDI by enforcing laws up to the standards of the EU, as well as according to the obligations undertaken with its membership into the WTO. However, the limited domestic market, the bad transportation infrastructure and complicated border procedures within the region, were some of the reasons why foreign investors were hesitant to invest in important projects in the country.

Back in the year of 2000, trying to increase the attractiveness of the economy for FDI, a law on creation of free economic zones as exemption from the enacted customs and fiscal rules was adopted. However, the zones were not active until 2008, when they were rebranded into Technological Development Industrial Zones (TDIZ). Foreign investors that would consider

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investment within the zones in production aimed for export out of the country were provided additional incentives and abundant subsides by the state. This approach was severely criticized by the academia and the domestic business sector, as it openly discriminated domestic in favor of foreign investors. Last year the arguments against the used model on attracting FDI were accepted which resulted in adopting a new policy on investment.

After a brief overview on the relevant theory on FDI, the paper analyzes the incentives on FDI provided in the former national policy on investment, than presents the most important finding of the VEC model on FDI run in 2017 for evaluating positive and negative effects from the incentives for foreign investors under the previous policy in the country, and at last, presents the new policy on investment defined at the end of 2018.

2. INCENTIVES PROVIDED FOR FOREIGN INVESTORS AND THE EFFECTS THEREOFF IN THE PERIOD FROM 2008-2017

The role of incentives for attracting FDI in countries of transition was thoroughly analyzed in the academic literature. Results of different researches led in this field were basically conflicting or with predominantly negative connotation. Most of the authors came to conclusion that the active approach in granting incentives to foreign investors might have strong negative impact upon the corruptive practices within the institutions of the system and might lead to withdrawal of the decision of a foreign investor to effectuate the investment. [1], [2] Cass F. investigated the role of fiscal and financial incentives, on one hand, and the policy applied by Investment Promotion Agencies (IPAs) in attracting FDI into European transition economies. [3] Abundant tax relieves usually have a negative impact on the total effect of the attracted FDI, as they increase the costs for the host country to an extent that might overcome the total positive effect of the effectuated foreign investment. It is even more important to point out that the up-to-date research in the area did not provide a proof on the statistically significant relation in attracting FDI neither with regard of institutional determinants nor in regard of financial and fiscal incentives. [4] Kalotay analyzed the FDI inflows in Bulgaria and Romania at the beginning of their EU accession process and found that despite the major labor costs and corporate tax advantages, these countries attracted relatively few efficiency seeking projects, mostly in garments and footwear. He further explains that in order to increase and materialize the FDI potential of these countries they need to improve the business environment by strengthening the judiciary system, fighting against corruption and organized crime in Bulgaria. [5]

Despite of the competition of providing various benefits and incentives for foreign investors, it is a fact that Western Balkan economies seem to be the least attractive for foreign investors. The main cause for this unattractiveness is the process of de-industrialization of WB economies. In 2014 the regional average share of manufacturing value added in GDP reached 12%, while the average share of services reached 62% of GDP. The regional average of realized FDI inflow was about 8% of the total GDP for the period from 2005-2014 and was more than two times bigger than the value of the same indicator calculated for the CEE economies at that time (3% of GDP). [6]

When speaking about the individual performance of the economies of the Western Balkans it is evident that the Macedonian economy has achieved very poor results and was overtaken by far by the Serbian economy which was considered to be the country with the biggest economic capacity for FDI in the region. However, the leading country by the amount of FDI per capita is Montenegro, which attracted 6,290 EUR per capita by the end of 2014.
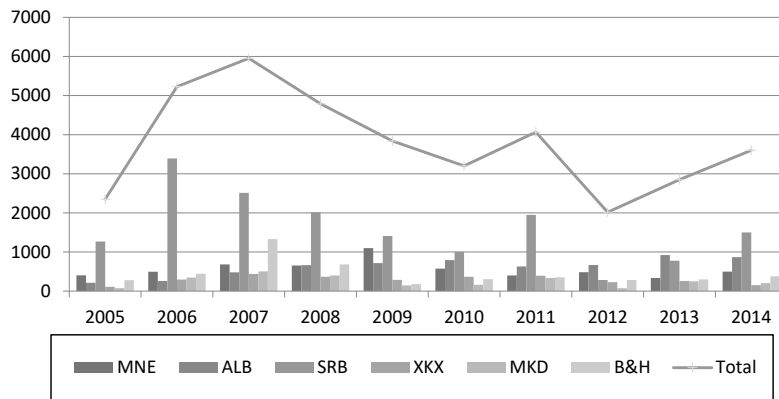
Graph 1: FDI inflow in Western Balkans in the period from 2005 to 2014 (in million EUR)
Source: WiiW database

The FDI inflow in Macedonia during the last two decades remained very low and created approximately 2.5-3% of GDP per year. Foreign investors were unwilling to invest in a small, landlocked economy, with a limited domestic market, lack of access to fresh capital, low level of productivity deriving from inconvenient and technologically outdated economic structure and poor transport infrastructure. The government tried to improve the business climate by significant reforms of the legal system, therewith trying to provide liberal provisions on FDI and guaranteeing foreign investors national treatment. Since 2008 the most influential enacted law in this area has been the Law on Technological Development Industrial Zones. [7] According to this Law, companies functioning within the TDIZ enjoyed various customs and fiscal exemptions and reliefs, as well as state subsidies for covering the costs for building plants, free construction licenses and free connection to water and gas pipe infrastructure. The government also was due to provide subsidies for creation of new working posts within the TDIZ, for covering costs of employees' trainings, as well as exemptions from the employees' personal tax and from the payment of the corporate income tax. The most important incentives that the government provided for foreign investors in TDIZ are presented in Table 1.

**Table 1:** Government incentives for foreign investors within the TDIZ since 2008

Incentives in infrastructure:	- Providing construction land for the new plants under a 99-year concession; - Free connection to the water and gas pipe infrastructure, free preparation of the construction land and free construction licenses; - Government participation in covering the building costs of new plants up to 500.000 Euro; - Tax exemptions for a 10-year period; 0% of VAT; 0% of Income Tax; 0% of Personal Tax.
State subventions in cash:	- Subsidies on creating of new working posts; - Subsidies on the payment of the corporate income tax; - Subsidies on the employees' personal tax; - Subsidies on costs for employees' trainings.

Source: *Official Gazette of the Republic of Macedonia. No. 82(08,103),* p.8

The abundant incentives for foreign investors provided with the Law on TDIZ significantly changed the perception of the foreign companies of the business climate in the country. Nevertheless, the inflow of FDI did not experience any improvements. On a contrary, right after

passing the Law on TDIZ and due to the economic crises in the EU back in 2009-2010, foreign investors started to withdraw money in the form of loans from their affiliations in the country. At the same time the amount of reinvested profit in the economy decreased substantially. Therefore, the amounts of outflow of capital overcame the inflows of capital in the economy. [8]

In the period since 2011 investment in the TDIZ intensified which resulted in strengthening of the position of the manufacturing sector, and within it, the position of the chemical industry. Other important manufacturing sub-sectors in the country that attracted additional foreign investment happened to be basic metals and fabricated metal products, food products, beverages and tobacco products, as well as motor vehicles, trailers and semitrailers. Graph 2 shows the economic structure of FDI at the end of 2015 in the country. [9]
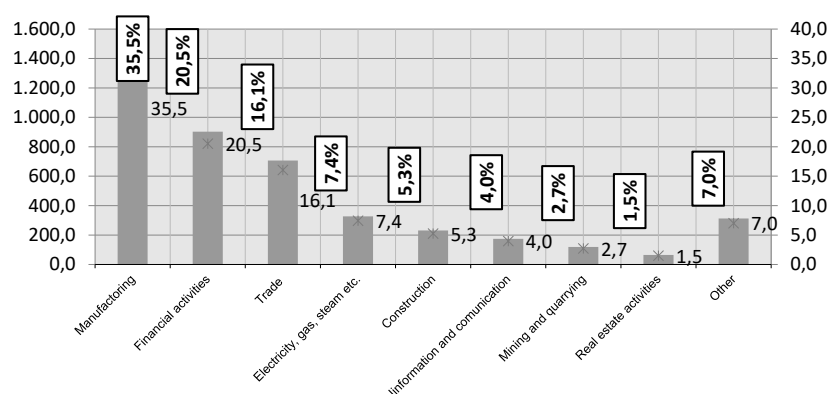
Graph 2: FDI economic structure in Macedonia in 2015 (millions of euro and %)
Source: Data used from www.nbrm.gov.mk

Despite the fact that the average FDI inflow at annual level did not change, the structure of the invested foreign capital changed significantly not only in regard of the industries, but also in regard of the form in which it was invested. Thus, the participation of green-field investment in the total amount of FDI began to increase. Prior to 2011 the dominant form of investment in the economy was mergers and acquisitions with a ratio of 38% versus 61% of the total amount of FDI in favor of the later. The established TDIZ managed to attract about 1.13 billion Euros of FDI in the form of green-field investment until the end of 2015. Invested capital predominantly originated from European economies, among which the biggest investors came from Austria, Great Britain, Germany and Turkey. Data on the changing structure of FDI according to the form of investment is presented in Graph 3.
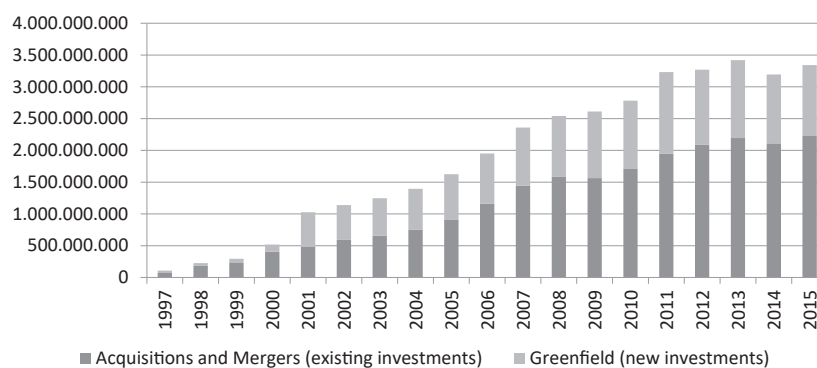
Graph 3: Greenfield investment and acquisitions & mergers in Macedonia
in period from 1997 to 2015 (in EUR)
Source: Data used from www.nbrm.gov.mk

The concept of attracting FDI with abundant incentives provided for investment in the TDIZ was severely criticized by the business community, as well as by the academia. The basic arguments were that the fresh capital that was invested in the economy was of a rather limited scope, and that the costs for attracting foreign investors overcome the positive effects of the capital invested in the country. This was the motive for us to construct a VECM on selected endogenous and exogenous variables potentially connected to the FDI inflow. As endogenous variables we used economic growth, labor productivity, openness to trade and current account balance. The exogenous factors were represented by political and institutional variables that have only one-way potential influence upon FDI inflows. The results of the VECM confirmed that economic factors, such as the ability to generate higher profits, openness to trade and cheap skilled labor force, were the leading factors for investing in Macedonia. Considering the relation in regard of availability of cheap labor, in many cases in Macedonia foreign investors created jobs by employing workers who were already employed in domestic companies which made tax incentives and costs on education for the newly employed highly expensive and ineffective. The dynamic analysis of the current account deficit confirmed that the effect of TDIZ in the first five-year period was generally small and as such resulted from higher initial import of equipment and materials at the time of founding the new facilities in the initial investment cycle, while more significant effects were registered in the last two years, when the effect on the deficit contributed to narrowing the negative gap in the current account. [11]

3.   THE NEW POLICY ON FINACIAL SUPPORT OF INVESTMENT

The applied policy on support of foreign investors was confirmed to be rather disputable in terms of open discrimination of domestic investors and of being a source of un-loyal competition on the labor market which made serious damage to domestic investors. The later lost the most skilled and experienced workers by not being able to offer them better payment due to the obligation to pay all duties and taxes to the government.

The severe critics on the previous model on FDI influenced the substitution of the old model with a new one that provides support of investment for both domestic and foreign investors on same terms. The basic preconditions for becoming a user of the state support are providing a prove on increment of company's revenues three years in a row with an unchanged average or with increased number of employees in the last year compared to the average number of employees in the last three years. [12] The short review on provided incentives with the new law are presented in Table 2.

Table 2: Eligibility for financial support according the new policy on investment

- Creation of new working posts:
- Establishing and enhancing cooperation with domestic suppliers;
- Technological R&D;
- Investment project of significant economic interest;
- Increment of capital investment and revenues;
- Repurchase of equipment from enterprises facing difficulties;
- Enterprises that increased their competitiveness on the market or increased sales on new markets.

Source: www.economy.gov.mk, last accessed on the 21st of May, 2019, pp. 3-4

The new model tries to eliminate or to improve some of the inconsistencies of the old model. Among the most important is termination of the predatory practice of overtaking well experi-

enced and skilled workers from domestic companies by defining a precondition for using the offered support only for new employees who were out of work for at least three months and were not employed by the same employee at least 12 months before; that are out of work because of bankruptcy of the company in which they used to work or were employed in public or state administration. [13]

The previous model did not create any spill-over effects for the Macedonian manufacturing companies, as only a dozen of small firms were engaged as suppliers of components for foreign investors' companies. This model provides financial support in amount of 1% of total value of supplied materials or a total of 300,000 Euros per year for companies that used at least 15% of the value of total input for their production in the previous calendar year from domestic sources. [14]

As projects with significant economic impact eligible for financial support is recognized investment of at least 4 mil. Euros that are going to create at least 300 working posts or investment of at least 20 mil. Euros. [15]

The financial support is going to be provided from 3 to a maximum 10-year period of time. [16]

CONCLUSION

The new model on financial support of investment was proposed at the end of 2018. Therefore, it could not be tested in practice, yet. Although, it tries to eliminate some defects of the old model especially in regard of open discrimination of domestic investors and predatory overtaking of skilled and experienced working force from domestic companies, the proposed model is still based on a direct state support and supports the existence of TDIZ. The incentives provided with the new model may cumulate with the incentives provided with the previous ones if the old agreement is still active and the company fulfills the new rules. It does not seem to create real opportunities for elimination of the influence of political and institutional inefficiencies. This model could also be disputable on a long run as the existence of TDIZ and abundant direct state support are not in compliance with the EU regulation.

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APENDIX I

THE LONG-RUN TREND OF THE FDI/GDP INDICATOR IN MACEDONIA

The long-run trend of the FDI inflow/GDP indicator represents a statistical analyzes, as well as an econometric estimation with regard of certain economic, political and institutional variables in Macedonia for the period from 2003 until 2015.

In our analysis the variables that have a potential influence upon FDI inflows are divided into two categories. The first category is represented by endogenous variables with a potentially mutual influence upon and from FDI. It consists of the following set of economic variables: economic growth, labor productivity, openness to trade and current account balance. We have used quarterly data for a period of 13 years (from the first quarter of 2003 to the fourth quarter of 2015) obtained from the National Bank of the Republic of Macedonia and the State Statistical Office of the Republic of Macedonia. The second category is represented by exogenous (political and institutional) variables with potential one-way influence upon foreign investment inflows. These variables are calculated as indexes based on yearly data obtained from the World Bank, World Governance Indicator database for the period from 2003 to 2015.

Table 1 presents the specification of endogenous (2-5) and exogenous variables (6-7) included in the econometric model, as well as the signs, calculation, source and results expected for each variable.

Table 1: Endogenous and exogenous variables taken into account

Variable	Sign	Calculation	Source	Expected sign
Foreign direct investment inflow	FDI	FDI inflow/GDP	NBRM	+
Economic growth	GDPG	Real GDP growth rate	NBRM	+
Trade openness	OPEN	(Export + Import)/GDP	NBRM	+
Labor productivity	LABPRD	GDP per employee (rate of growth)	NBRM	+
Current account balance	BP	Current account balance/ GDP	NBRM	+ -
Index of institutional factors	INSTIT	Calculated as Index based on Corruption and Rule of law percentile rank for a country	World Governance Indicator, World Bank	+
Index of political factors	POLICY	Calculated as Index based on Political stability, Government Effectiveness and Regulatory Quality percentile rank for a country	World Governance Indicator, World Bank	+

A simple statistical approach provides an opportunity to obtain certain information and warnings, and draw some conclusions. However, these findings need to be further tested and validated by applying more complex models and methods. The econometric approach tries to explain the level of FDI inflows as a function of certain economic, political and institutional variables.

The FDI/GDP ratio is calculated as a function of certain fundamental variables and the "normal value" of this ratio is assessed. For this purpose, we have used VECM (the Vector Error Correction Model) in the following form:

$$\Gamma_0 \Delta y_t = \alpha \ [\beta' : \eta'] \begin{bmatrix} y_{t-1} \\ D_{t-1}^{co} \end{bmatrix} + \Gamma_1 \Delta y_{t-1} + \ldots + \Gamma_p \Delta y_{t-p} \quad + B_0 x_t + \ldots + B_q x_{t-q} + CD_t + u_t \qquad (1)$$

Where y_t is a vector of endogenous variables (FDI, GDPG, BP, LABPRD, OPEN), X_t is a vector of exogenous variables (POLICY, INSTIT) and D_t contains all determinant components.

In order to investigate the possibility of non – stationarity in the dataset, we used Augmented Dickey Fuller test for stationarity, and the **results of the unit root test** showed non – stationarity in the endogenous variables. To check the validity of the VECM model, we did a few diagnostic tests and found that the residuals of the regressions have normal distribution and do not show any auto – correlation.

Table 1 (Appendix) presents the descriptive statistics of both the endogenous and exogenous variables of the model. It demonstrates the mean, median, maximum, minimum, standard deviations as well as skewness and kurtosis values of the 52 observations associated with each of the 7 variables used in the study. According to the information criterion in the Table 2 (Appendix), especially SC (Schwarz information criterion) and HQ (Hannan-Quinn information criterion) based on unrestricted VAR, the number of lags in the model should be one.
Table 2 presents the long-run relations and their significance between the FDI indicator and other economic, political and institutional variables.

Table 2: Estimation of the model co-integration equation

Variable	Coefficient	t-statistic
GDPG	1.072193	2.49731*
OPEN	0.967329	6.00903*
LABPRD	0.550584	1.97861**
BP	-0.136292	-1.46816***
POLICY	0.149369	0.72078
INSTITUT	-0,204886	-1.05004

Note:
* means level of significance of 1%,
** means level of significance of 5%,
*** means level of significance of 10%

According to the results obtained, there is a long-run relationship between endogenous (economic) variables and the FDI indicator, with different levels of significance for each variable. The highest level of significance of 1% is found for the long-term relationship between FDI on one side, and economic growth and openness to trade, on another side. The level of significance of the labor productivity long-term parameter is 5%, while the current account balance parameter has the lowest level of significance of 10%. Additionally, there is an insignificant long-term influence of the political and institutional variables on FDI inflows. According to the results obtained, we can conclude that economic factors (primarily the ability to generate higher profits, openness to trade and the cheap skilled labor force) constitute leading factors for investing in Macedonia.

Table 3: Descriptive statistics parameters

	FDI	GDPG	BP	LAB PRD	OPEN	POLICY	INSTITUTIONAL
Mean	3.8	3.4	-4.1	1.7	98.3	47.1	47.6
Median	2.6	3.4	-3.8	0.5	103.6	46.8	51.7
Max	21.4	10.7	7.2	12.6	120.0	61.0	57.9
Min	-1.1	-3.7	-21.1	-10.5	67.5	36.5	32.4
Std. Dev.	3.7	3.7	6.4	5.1	15.1	6.4	7.4
Skewness	2.3	0.2	-0.7	0.2	-0.4	0.2	-0.6
Kurtosis	11.0	2.2	3.6	2.9	2.0	3.0	2.2
Observations	52	52	52	52	52	52	52

The long- run parameter of the economic growth (**GDPG**) is positive and highly significant, showing that if real GDP growth rate increases by 1 percent, then the FDI inflows will increase on average by 1.072193 percent, assuming all other factors unchanged. Moreover, this positive relation is in accordance with our initial expectations and has credible theoretical background by its own definition. As a rule, the market size has a positive relation with FDI, which means that a larger market and a market that is increasingly growing will receive larger inflows of FDI. On the other hand, growth enhancing the acceleration of FDI inflow suggests that the increase in FDI causes a positive reaction to the economic growth in Macedonia.

With regard to the openness of the economy (**OPEN**), a positive and highly significant long-run relation has been obtained, assuming all other factors unchanged. The research points to the importance of an open economy for attracting FDI. This is in accordance with our initial expectations and is also found in some previous empirical studies. Countries that want to attract more FDI ought to increase foreign trade exchange as well (Aiedu, 2006). At the same time, some empirical studies (Aiedu, 2006; Vijayakumar et al. 2010) argue that countries which receive less FDI would be more attractive if they implemented reforms that liberalize their foreign trade.

Table 4: The number of lags in the model

VAR Lag Order Selection Criteria
Endogenous variables: FDI GDPG BP LABPRD OPEN
Exogenous variables: C POLICY INSTITUTIONAL
Sample: 2003Q1 2015Q4
Included observations: 48

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-527.9205	NA	69274.48	22.49669	22.96449	22.67347
1	-491.1196	62.86813	29344.33*	21.62999	22.72152*	22.04248*
2	-477.4098	21.13605	33091.90	21.72541	23.44067	22.37361
3	-464.2882	18.04221	39353.52	21.84534	24.18434	22.72925
4	-439.8703	29.50489*	30516.08	21.49460*	24.45733	22.61422

* indicates lag order selected by criterion

The labor productivity (**LABPRD**) long-run parameter is positive and significant, with a lower level of significance of 5%, which shows that if the labor productivity increases by 1 percent, then the FDI indicator will increase by 0.550584 percent on average, assuming all other factors unchanged. Given the growth rate of labor productivity is increasing the amount of GDP per

employee we can conclude that attractiveness for investment in Macedonia is increasing with the ability to generate more revenue per employee. Taking into consideration that FDI enable the creation of new jobs, productivity growth would mean faster GDP growth relative to the increase in number of employees. On the other hand, as a result of FDI, application of modern technology and know-how is expected, which would in turn encourage the growth of productivity. Even though the result was in line with our initial expectations and theoretical background in mind, it is necessary to take into account the fact that the relationship is at a lower level of significance of 5% and this long-term placement of parameters is not as pronounced in this respect. Therefore, it is necessary to take into account the fact that in many cases foreign investors create jobs by employing workers who were already employed in domestic companies. In this case of unchanged number of employments, the state faces higher costs due to its state tax incentives and education for the newly employed.

The long-run parameter of the current account balance (BP) is negative and with a weak level of significance of 10%. The inverse relation is a result of the FDI inflow influences in reducing the current account balance of payment's deficit. This is in accordance with the NBRM paper analyzing the effects of companies' activity in TDIZ on the balance of payments of the Republic of Macedonia, where it is stated that the operation of new companies improved (narrowed) the current account deficit by an average of 0.3 percentage points of GDP in the past seven years. Namely, the average current account deficit in the period 2009-2015 amounted to 2.6% of GDP, while if the activity of the new companies was excluded it would be 3.0% of GDP. The dynamic analysis of the current account deficit is a useful explanation of our results relating to the weak significance between FDI and current account balance, showing that the effect of TDIZ in the first five-year period is generally small and such dynamics of the current account balance results from higher initial import of equipment and materials at the time of founding the new facilities and the initial investment cycle, while more significant effects were registered in the last two years, when the effect on the deficit contributed to narrowing the negative gap in the current account.

If we look at the institutional and political variables with potential influence on FDI separately, we can consider that the Index of Political Factors **(POLICY)** based on Political Stability, Government Effectiveness and Regulatory Quality percentile ranks for a country, has a positive relation with the FDI indicator. This index captures the perceptions of the ability of the government to formulate and implement sound policies and regulations, quality of public services, the degree of independence from political pressures, as well as the likelihood of political instability. Hence, greater government credibility and political stability have greater potential to accelerate the FDI inflow in the country.

The Index of Institutional Factors **(INSTITUT)** is calculated as an index based on the Corruption Percentile Rank for a country (captures the perceptions of the extent to which public power is exercised for private gain) and the Rule of Law Percentile Rank for a country (captures the perceptions of the extent to which agents have confidence in the quality of contract enforcement, property rights, the police and the courts). According to the results obtained, there is an inverse insignificant influence of the index of institutional factors on FDI in Macedonia. The inverse relation between FDI and institutional factors may indicate that the lack of transparency, low quality of contract enforcement, insufficient control of corruption and inefficient courts may attract more FDI inflows as a result of greater opportunity for profit generation in a country with lower levels of institutional regulation.