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Measuring Spillover Benefits from Foreign Direct Investment in the Republic of North Macedonia

A külföldi közvetlen beruházások tovagyűrűző előnyeinek mérése az Észak-Macedón Köztársaságban

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KÜLÜGYI ÉS KÜLGAZDASÁGI INTÉZET

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Abstract: Foreign Direct Investment (FDI) plays an important role in a country's growth and development. By attracting foreign investors, the generation of spillover in the host economies is expected because FDIs also transfer intangible assets to the affiliate, which may then diffuse to local firms. Despite years of wars and ethnic tussle, late transition, and financial and political crises, the Republic of North Macedonia has experienced significant FDI inflows in the last decade. This is due to an improved business climate and better policies for attracting foreign investors. The aim of this study is to analyse and estimate the benefits from FDI in North Macedonia, between the period 2005-2018. The goal is to determine whether there is any positive correlation between FDI, the GDP, employment rate trends, and export. For the analysis, data from the Macedonian State Statistical Office, UNCTAD, the National Bank of the Republic of North Macedonia, and the World Bank is used. The main findings suggest that there is a positive correlation between FDI and the GDP, employment rate trends, and export.

Összefoglaló: *A külföldi tőkebefektetések (Foreign Direct Investment, FDI) fontos szerepet játszanak egy ország növekedésében és fejlődésében. A külföldi befektetők becsábításától további tovagyűrűző hatásokat remélnek a célgazdaságban, mivel a befektetésekkel immateriális javak is érkeznek, amelyek elterjedhetnek a helyi cégek között. A háborús évek, az etnikai feszültségek, a kései átmenet, a pénzügyi és a politikai válság ellenére az Észak-Macedóniai Köztársaságban jelentős külföldi tőkebeáramlást lehetett tapasztalni az elmúlt évtizedben. Ez a javuló üzleti környezetnek és a külföldi befektetőket célzó jobb politikának köszönhető. Az elemzés célja az Észak-Macedóniába áramló FDI előnyeinek vizsgálata és megbecsülése a 2007 és 2018 közötti periódusban. A cél annak feltárása, hogy van-e pozitív összefüggés az FDI, a bruttó nemzeti össztermék (Gross Domestic Product, GDP), a foglalkoztatási ráta és az export között. Az elemzéshez a Macedóniai Statisztikai Hivatal, az UNCTAD, az Észak-Macedóniai Nemzeti Bank és a Világbank adatai kerültek felhasználásra. Az eredmények arra utalnak, hogy pozitív korreláció van az FDI, valamint a GDP, a foglalkoztatási ráta alakulása és az export között.*

Introduction

Foreign Direct Investment (FDI) is not just a transfer of capital from one country to another, it is also accompanied by potential spillovers. The latter are potential external effects which have an impact on productivity levels, technology improvement, and know-how in the host country by a transfer of managerial and technical skills in management, and the dissemination of knowledge and entrepreneurship in the form of research and development (R&D), production technology, and marketing. FDI is very important for developing countries, as it is considered a vital source of development. However, it is not an easy task to measure the effects of FDI in the host country, as there can be numerous effects, both direct and indirect.

North Macedonian policy makers are putting a lot of effort in attracting FDI, as it is a main factor in increasing employment, and supporting economic development and GDP. Since 2000, there has been an increased inflow of FDI in the Republic of North Macedonia, both in the manufacturing and the service sectors. The North Macedonian government has pushed an aggressive marketing campaign to attract investors. Factors affecting FDI include great geographical location, cheap skilled labour force, and a positive investment environment. In order to support foreign investments, the North Macedonian government has introduced investment packages, established Trade and Industrial Development Zones (hereinafter TIDZs), put emphasis on becoming a member in international associations, and simplified administrative procedures. Furthermore, policy makers have adopted global methodologies and standards for the preparation and evaluation of projects, and legal guarantee of property has been secured. Foreign investors are offered subsidies and incentives, grants for construction, and zero percent tax on reinvested profit and retained earnings.

These benefits offered to investors raise the question whether investors' intention is only short-term, whether investors are only interested in reaping the benefits and leaving the country after the subsidies are no longer available to the investor; whether investors only want to take advantage of the cheap labour force.

The aim of this research is to analyse the potential benefits from FDI in North Macedonia. They will be evaluated based on their contribution to the GDP, the employment rate, and export. Data from the Macedonian State Statistical Office, World Bank, UNCTAD, and the National Bank of the Republic of North Macedonia will be used for the analysis. The main hypothesis is that FDI has a positive overall impact on the Macedonian economy.

FDI and Spillovers

FDI is accompanied by potential spillovers, which can be defined as potential external effects which have an impact on productivity levels, technology improvement, and know-how in the host country. Beside being an important source of capital, the most important aspect of FDI inflows in the host country is that FDI has an impact on economic growth and the development process by bringing new know-how and new technologies to the host countries. FDI is the biggest developmental opportunity for companies from the Western Balkan countries (WBCs), and the best way to increase production, employment, export, and living standards in the long term. Zugic states that FDI entry into transition countries brings capital, technology, know-how, and the maintenance and development of their international competitiveness.

According to Selimi, there is no dilemma that the benefits of FDI in the host countries are greater than the potential damage. By entering a foreign market through FDI, Neffke and Henning state that MNCs transfer some superior knowledge and technology to their affiliates. It is assumed that some of these assets spill over to other (domestic and foreign) firms in the host country.

FDI can create both positive and negative spillovers, hence the important question for host countries is which of these spillovers is dominant. The existing literature on the spillover effects of FDI is divided on this issue. Important contributions on the effects of FDI on host countries have been made by Caves; Rappaport; Borensztein et al.; De Mello; Blomström et al., and Javorcik.

Caves has observed several positive effects of FDI, such as productivity gains, technology transfers, and the introduction of new processes, managerial skills and know-how in the domestic market, employee training, international production networks, and access to markets. In addition, De Mello concludes that FDI may contribute to the growth of the host country's economy. This could happen by transfer of technology, which raises the stock of knowledge in the host country through labour training and skill acquisition, new management practices, and organisational arrangements.

According to Rappaport, FDI may improve the productivity both of the firms receiving investments and all the firms of the host country as a result of technological spillovers. These spillover effects, as stated by Javorick, are generated both from intra-industry (or horizontal, i.e. within the same sector) externalities and inter-industries (or vertical) externalities through forward or/and backward linkages. Therefore, Borensztein et al.'s results suggest that FDI is an important vehicle for technology transfer, and that FDI contributes relatively more than domestic investment. However, higher productivity of FDI holds only when the domestic economy has a minimum threshold stock of human capital. Blomström et al. show that a positive growth effect of FDI may be real whether the country was sufficiently rich or not.

On the other hand, some analyses show that MNCs can have negative spillover on the productivity of companies in the host country. Foreign firms may have a negative effect on domestic firms' efficiency if they "steal" their market. De Mello points out that "whether FDI can be deemed to be a catalyst for output growth, capital accumulation, and technological progress seems to be a less controversial hypothesis in theory than in practice." Moreover, after carrying out macro empirical research, Lipsey claims that a consistent relation between the size of inward FDI stocks or flows relative to GDP and growth does not exist.

Blomström – Kokko conclude that FDI may promote economic development by improving productivity growth and export in the host countries, but the exact relationship between foreign multinational corporations and their host economies seems to vary among industries and countries. Foreign firms may also have a negative effect on domestic firms' efficiency if they "steal" the host country's best human capital. Similarly, Gorodnichenko et al. explain if the best employees leave for foreign firms, efficiency declines. Konings also finds negative spillovers to domestic companies in Poland and no spillovers to domestic companies in Romania and Bulgaria.

History of FDI in the Republic of North Macedonia

In the 1990s, the former socialist countries began the process of transition, which meant moving from a planned economy to a market economy. This required significant reforms, and the inflow of FDI and fresh capital became crucial for development. From a financial perspective, the countries in transition had a different standpoint than Western European ones. They were limited in their financial assets, and therefore the need for an inflow of foreign funds was immense.

In the early stages of FDI in transition countries, most FDI was in the form of the takeover of the privatized enterprises or through joint ventures with local companies. There was immense need for green-field investments and it was crucial to attract this type of FDIs. Initially, the primary motivation for investors when deciding to invest in transition economies was to conquer new markets. The secondary motivation was a cheap labour force and low production costs.

At the beginning of the process of transition, most Balkan countries faced a scarcity of capital for the transformation of their system based on a planned economy. All Western Balkan countries (originally including Croatia, Bosnia and Herzegovina, Serbia, Albania, Montenegro, Kosovo, and North Macedonia, hereafter: WBCs) had different approaches for attracting FDI and for restructuring their economy. This is mainly due to the social, cultural, and ethnic differences between the countries.

In the case of North Macedonian privatization, 62% of enterprise assets were sold to insiders. Most of these new owners did not provide fresh capital and could not offer the needed know-how and technology. Sales to foreign investors was only 1%. In Hungary, the situation was the opposite: 48% of the enterprise assets were sold to foreign investors and only 9% to insiders. This provided new technology, know-how, skills, and capital in Hungary right after the end of communism. Table 1 shows the distribution of enterprise assets among methods in selected CEE countries and the Republic of North Macedonia, based on Kalotay – Hunya.

Table 1.
Distribution of enterprise assets among privatization methods in selected CEE countries and the Republic of North Macedonia until 1998 (in %).

Country	Sales to foreign investors	Sales to domestic investors	Equal access vouchers	Insider	Still state Property	Other
North Macedonia	1	1	-	62	12	24
Czech Republic	15	15	40	5	5	20
Hungary	48	13	-	9	-	43
Slovakia	7	3	25	30	5	30
Slovenia	1	8	18	27	21	25

Source: Kalotay – Hunya, 2000.

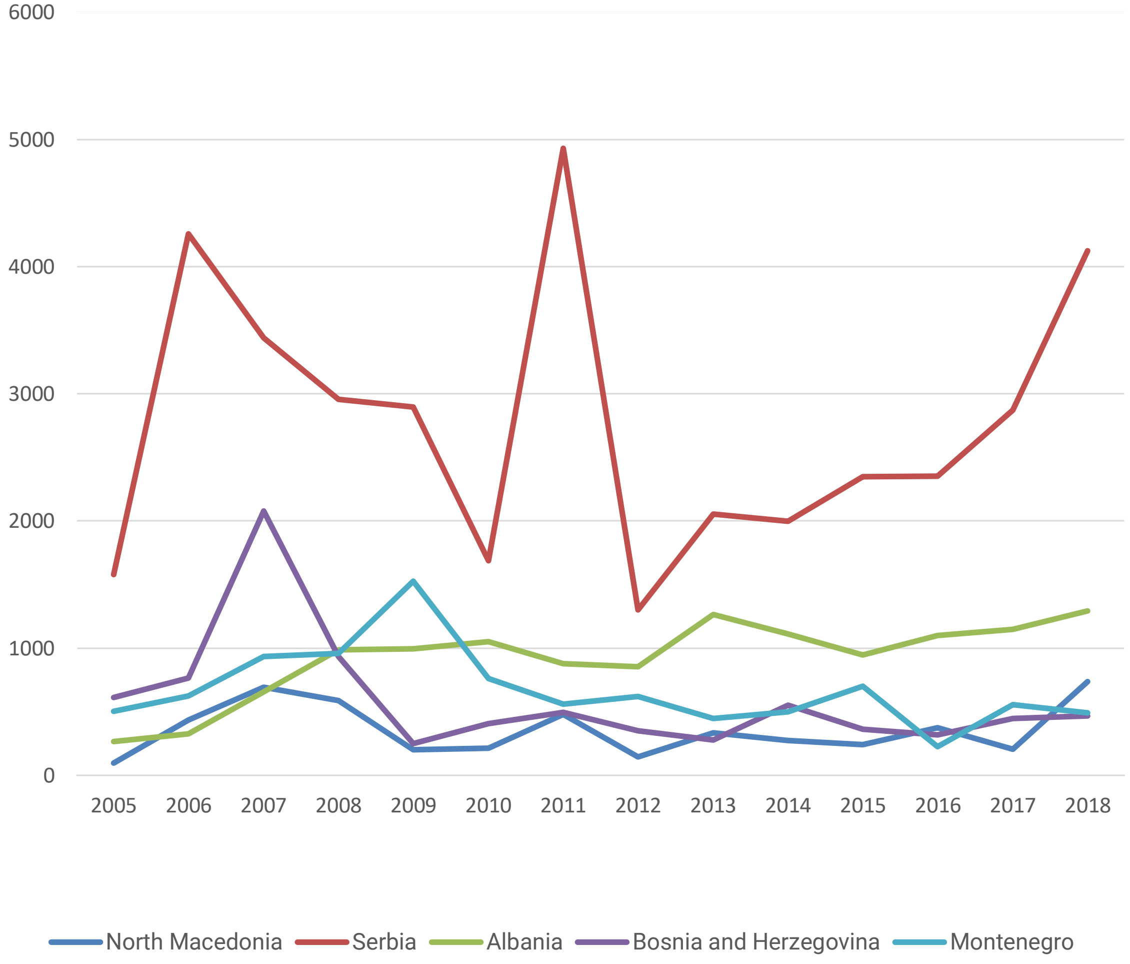
According to Zugic, FDI in the WBCs, including the Republic of North Macedonia, stagnated in the first phase of transition. This region received a relatively small amount of FDI. These developments correspond to the occurrence of privatization deals. Zakharov and Zugic conclude that in this region, export-oriented manufacturing FDI is very rare. The problem with the privatization is that, instead of creating new jobs, after the sale of domestic enterprises, there is a surplus of workers who become redundant.

Another structural problem of the WBCs is that the model of growth of is based exclusively on FDI. If a country is solely dependent on FDI and does not think about production, export competitiveness, and a better quality of life, it is bound to become a loser in the long term.

Trends of FDI in the Republic of North Macedonia

Figures 1 and 2 show a comparison of FDI inflow in North Macedonia and other WBCs (Serbia, Albania, Montenegro, and Bosnia and Hercegovina). It is visible that Macedonia is constantly at the bottom of the list. During the examined period, North Macedonia attracted a very small amount of FDI compared to the other WBCs.

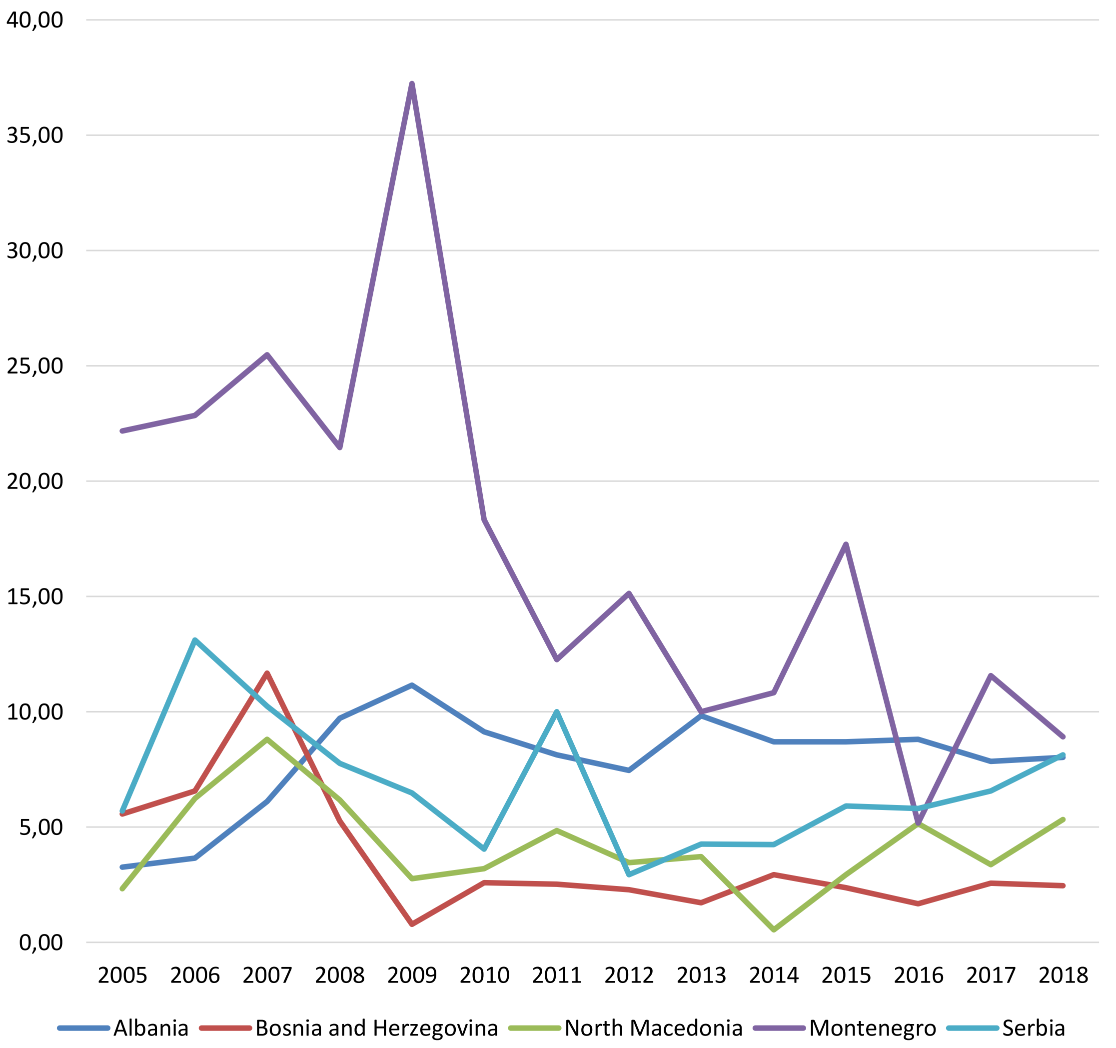
Figure 1.
Inflow of FDI in the
Western Balkan Countries 2005-2018 (in USD million)



Source: UNCTAD, World Investment Report
(2011, 2012, 2013, 2014, 2015, 2016, 2017, 2018, 2019)

In order to attract foreign investors, starting in 2006, the government undertook several actions to tackle these challenges. It introduced a number of measures and incentives to address the main concerns of foreign investors at that time. Among others, a one-stop shop for registration of foreign investors was introduced, which reduced the time foreign investors spent in the initial stages of investment.

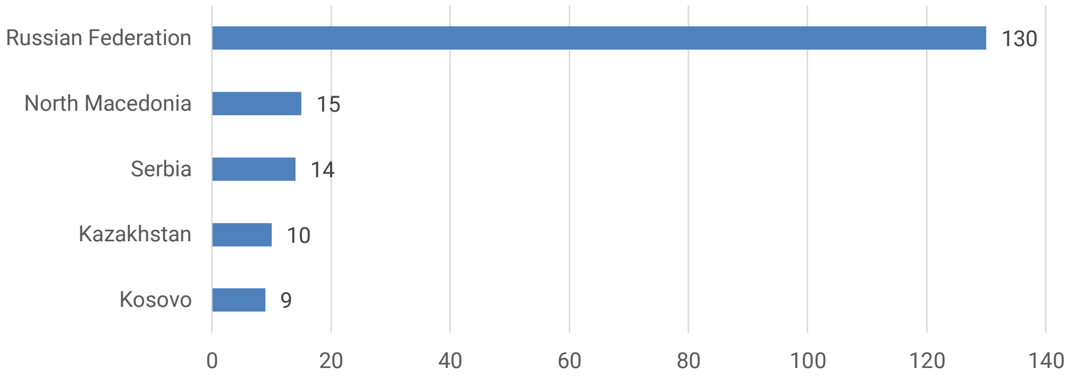
Figure 2.
FDI net inflow as a percentage of total GDP 2005-2018,
a comparison between the Republic of North Macedonia
and other WB countries



Source: [World Bank Group, 2019. Western Balkans Regular Economic Report No. 15, Spring 2019: Reform Momentum Needed. World Bank, Washington]

Moreover, amendments were introduced to strengthen legislation on mortgages and bankruptcy. Property rights were secured. Today in North Macedonia there are 15 Technology and Industrial Development Zones. Among the transition economies, North Macedonia is ranked second, after the Russian Federation, which has 130 TIDZs. From the Western Balkan countries, only Serbia and Kosovo among the transition economies are on this list, having 14 and 9 TIDZs, respectively (Figure 3).

Figure 3.
Transition economies with the most
Special Economic Zones (SEZs), 2019



Source: [UNCTAD, World Investment Report, 2019]

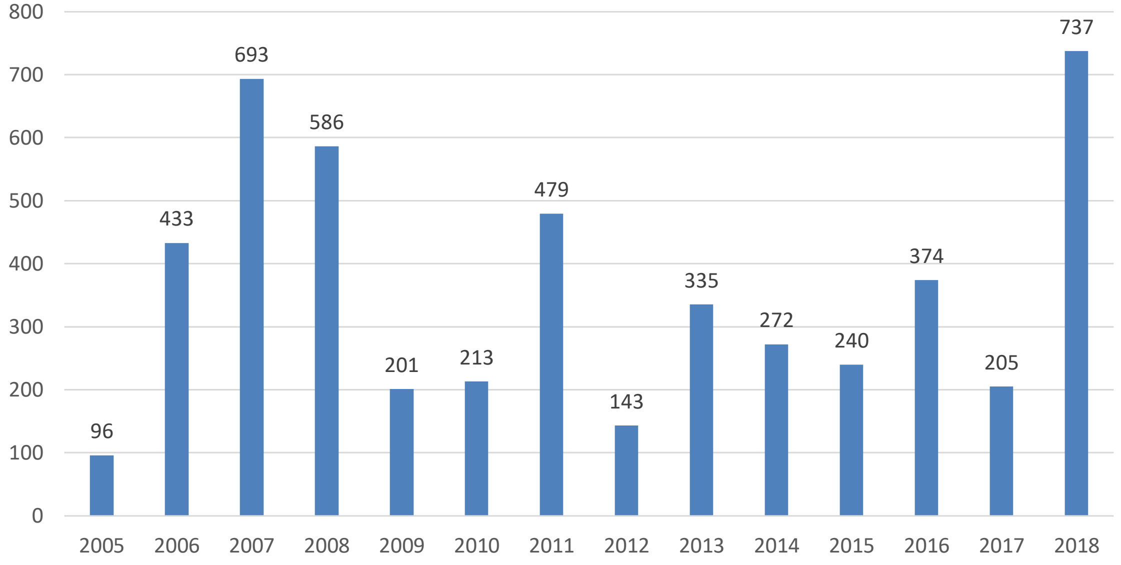
The concept behind these TIDZs is that TIDZs are one form of the instruments helping in the promotion and implementation of the FDI policies. In particular, they aimed at accelerating the economic development of North Macedonia, by attracting both foreign and domestic capital, which is important for the development, introduction, and application of new and advanced technologies in the national economy. In this way, these new capabilities, skills, and know-how will increase competitiveness and employment. In these zones, foreign investors enjoy special privileges. Every company based in one of these TIDZs with foreign capital can leverage benefits from the government to achieve its goals and profit. These benefits include a number of tax and non-tax exemptions.

North Macedonia being ranked second signals that the country is undertaking significant activities to accelerate export activities. Moreover, the country has recently strengthened the law on TIDZs, as it requires zone users to meet certain criteria, such as job creation, compliance with high environmental standards, production based on new technologies, and high energy efficiency, as shown in the UNCTAD report.

In 2005, FDI inflows were at a very low level, amounting to USD 96 million. In 2006, FDI increased significantly, to more than four times compared to the previous year. This is due to the above-mentioned new FDI policies and the attractive foreign investors' package. The North Macedonian government has engaged in implementing investor-friendly policies and a well-targeted and defined campaign in order to attract foreign investors. In 2007, FDI inflows were USD 693 million, keeping the rising trend.

However, the impact of the global economic crisis hit North Macedonia as well. In 2009, FDI decreased significantly, with inflows as low as USD 201 million, stagnating at this level in 2010. From 2011 to 2012 there was a significant FDI decrease, which was a consequence of the outflow of foreign-owned firms' profits. Although the economic crisis played a major role in FDI investment restrictions, corruption and the slow pace of EU integration were the main factors in decreasing Macedonia's attraction of FDI (National Bank of Macedonia, 2013).

Figure 4.
Inflow of FDI in the Republic of North Macedonia 2005-2018
(in USD million)



Source: UNCTAD, World Investment Report
(2011, 2012, 2013, 2014, 2015, 2016, 2017, 2018, 2019)

In 2013, FDI increased again, but starting that year, the country had three consecutive years where the FDIs inflows were decreasing. Investments are particularly vulnerable to political instability. During this period the country underwent a political crisis and a change of government. It is not always easy to say in advance how politics will affect the economy, but in North Macedonia this was very clear. As stated by Hunya, economic growth came to a standstill, FDI halved. In 2014, the largest greenfield investment in North Macedonia was announced by the Turkish textile company Weibo. This investment was supposed to create approximately 4,500 new jobs, with an estimated capital expenditure of USD 4,500 million. However, this investment never realized, as in 2016 the company decided to invest in Serbia. In 2016, FDI increased substantially, following the change of government in the country. In the same year, FDI flows to the country grew by 65%, as the UK company Hystead Ltd bought Skopje City Mall, a shopping mall operator, for USD 100 million. This was the most significant investment in 2016.

After a low FDI inflow in 2017, in 2018 FDI flows tripled and amounted to a record USD 737 million. Most FDI targeted the export-oriented investment cluster, mostly the automotive production, located in one of the country's TDIZs. One of the largest deals was in TIDZ Skopje 2, which attracted the United States-based car parts manufacturer Dura Automotive Systems. According to the World Bank report, the country has positive prospects for growth in the upcoming period.

Flows to North Macedonia were a result of both favourable international demand for the products of foreign firms located in the country, but also due to positive political developments with regard to the country's historic name dispute with Greece. This facilitates North Macedonia's cooperation with the EU, the country's main export market. Equity investment rose two and a half times, and intracompany loans turned positive after negative flows in 2017. Beyond the traditionally strong automotive cluster, new investments were also recorded in other activities. Caffè di Artisan (United Kingdom), for example, invested in high-end food products in the country, as shown on the UNCTAD report.

According to the Santander Report, the number of greenfield investments decreased. In 2016, there were 20 realized greenfield investments, 11 in 2017, and 13 in 2018. This is a good sign for the economy because concentrating on attracting greenfield investment will create more jobs, and new products and services.

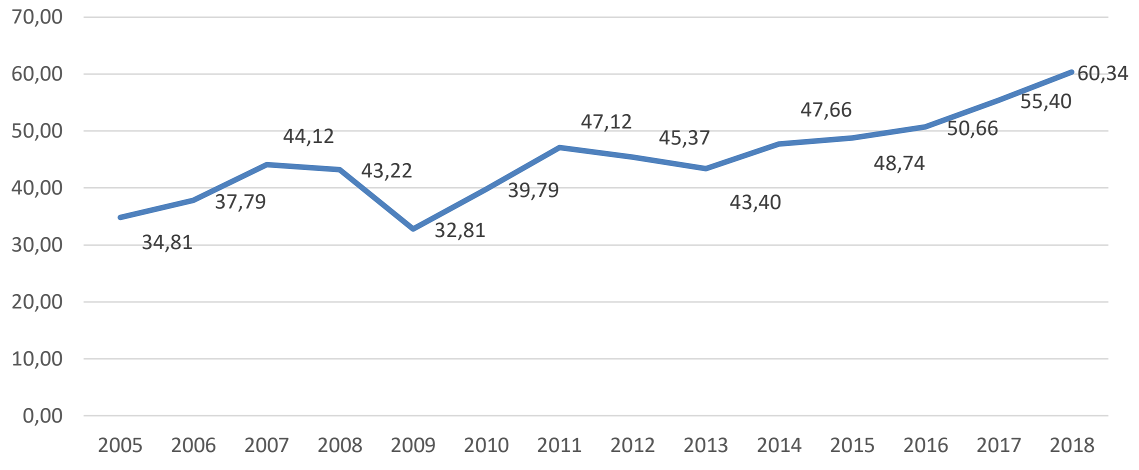
Table 2.
Number of employed people
and the unemployment rate, 2008-2018

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Number of employed people	609015	629901	637855	645085	650554	678838	690188	705991	723550	740648	759054
Unemployment rate	33.8%	32.2%	32.0%	31.4%	31.0%	29.0%	28.0%	26.1%	23.7%	22.4%	20.7%

Source: SSO, 2019

Table 2 shows the number of employed people and the unemployment rate. According to the Macedonian State Statistical Office (SSO), in the period between 2008 and 2018 the number of employed people increased year by year, resulting in a decreasing unemployment rate. The IMF report shows that the employment of FDI companies was about 2.5% of total employment as of September 2016. However, at full capacity, the employment of foreign companies in North Macedonia would have reached about 4.7% of total employment. According to the data provided by the Public Revenue Office of FYR Macedonia, companies within the TIDZ paid social security contributions and personal income tax in the amount of MKD 1.1 billion during 2011–2015, or approximately 0.16% of total tax revenues and contributions per year (IMF, 2016).

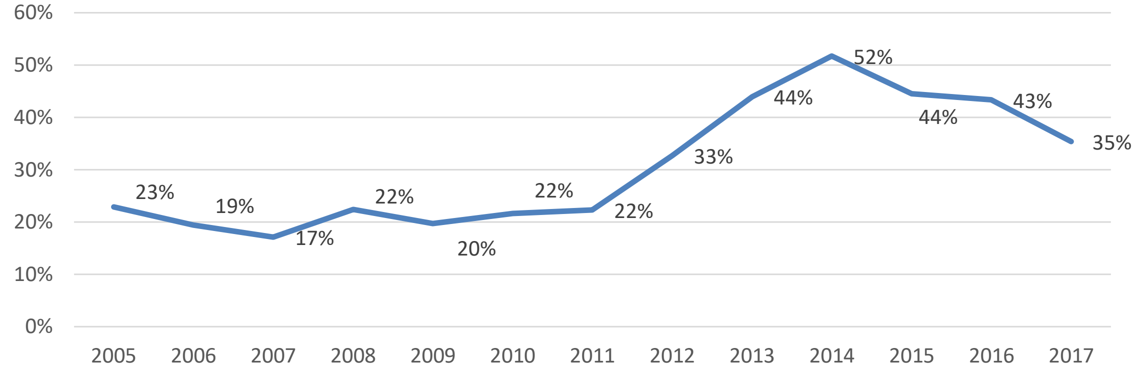
Figure 5.
Export of goods and services as % of GDP, 2005-2018



Source: [World Bank Group, 2019. Western Balkans Regular Economic Report No. 15, Spring 2019: Reform Momentum Needed. World Bank, Washington]

Figure 5 shows the trend of export of goods and services from 2005 until 2018 in the overall economy. There is a lack of data only for the TIDZs. However, an estimate prepared by the National Bank of the Republic of North Macedonia (NBRM), based on customs foreign trade data shows that exports from TIDZs are about 42% of total goods exports, and imports to the zone around 25%, with overall net exports contributing to 2.6% of GDP during 2014–15, according to an IMF report. This data is significantly high, meaning that foreign companies do contribute to the economic growth.

Figure 6.
Total R&D expenditure, 2005-2017 (% of GDP)



Source: [World Bank Group, 2019. Western Balkans Regular Economic Report No. 15, Spring 2019: Reform Momentum Needed. World Bank, Washington]

Figure 6 shows the total R&D expenditure in the examined period. At first glance, the R&D figures are high for such a small country, but in reality business expenditure is very low, as shown in Table 3. The government introduced several incentives (lower taxes and zero corporate tax on all profits that are re-invested into the development of a company). Despite all these measures, the R&D expenditure of the business sector has remained very low. Due to a lack of data, for 2018 data from UNESCO was used, which shows that R&D expenditure stagnated and amounted to 0.5% of the GDP.

Table 3.
Research and Development expenditure in the business sector (% of GDP)

	2005	2006	2007	2008	2009	2010
R&D expenditure in the business sector (in million MKD)	129743	79616	147477	264695	172487	108820
R&D expenditure in the business sector (% of GDP)	0.42	0.24	0.39	0.64	0.42	0.25
Researchers in R&D (per million people)	545	519	506	471	434	534

Source: SSO, 2016

In 2019, according to the Santander report, North Macedonia's regulatory and legal framework is favourable to foreign investors. The country has made significant efforts to harmonize its legal framework with the European Union's standards and practices. In the report, the country is characterized by having an investor-friendly climate, fast procedures, and FDI-friendly policies, low labour costs, high-quality workmanship, and a stable democracy. But there are some challenges as well. The country has high structural unemployment and a training deficit, so investors might face a shortage of skilled labour. Also, there is an inadequate transport infrastructure, corruption, lack of transparency, poor customer service, excessive bureaucracy, political interference in the judiciary, lack of government capacity, and communication difficulties and shortcomings in the rule of law and contract enforcement. The informal economy is quite significant in size, and there is a conflicting political landscape.

Conclusions

The direct FDI benefit on the host country is generally measured by FDI contributions to the GDP, the employment rate, and export. In the case of North Macedonia, based on the figures and statistics FDI has had a positive impact on export. More than 40% of the total export of goods and services were from the TIDZs. This is very important especially because in the past WBCs and North Macedonia did not use FDI for production or export projects. We can conclude that in this segment FDI has had a significant positive impact on the host country.

The unemployment rate was decreasing in the examined period. However, as per IMF estimates, employment in the FDI companies was only 2.5% of the total employment, which is a very low figure. Nonetheless, it should be added that a lack of reliable data on this aspect makes it difficult to measure the exact impact of FDI on employment.

The Macedonian government should find ways to stimulate and increase the R&D expenditure of companies, since as of now this expenditure is very low. To increase these levels, the government could introduce fiscal deductions or subsidies for importing R&D equipment. Another option could be a policy for firm innovation, but also promotion of collaboration and networking among the firms at the national level.

The North Macedonian government will need to put even more emphasis on attracting FDI. In the last few years, policy makers have done a good job, but compared to the other WBCs and their FDI inflows, North Macedonia is still lagging behind. Also, there have been a couple of examples where the country could not compete with other WBCs to lure in important investors. Accordingly, a follow-up policy should be put in place along with an upgraded policy strategy to attract more FDI and to retain existing investors. The most important step is to compare the potential FDI benefits with the actual cost of attracting foreign investors. So far, the Macedonian government has not been transparent, and there is no official information about the amount that the government is spending on these incentives.

Last but not least, the reforms should ensure sustainable working conditions. The most important element is to work on improving political stability, create a more predictable business climate, and reduce the perception of corruption.