POSITIONING FYR MACEDONIA FOR THE GLOBAL ECONOMY: THE IMPACT OF REFORMS AND INVESTMENT PROMOTION IN THE AUTOMOTIVE COMPONENTS MANUFACTURING SECTOR

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Acronyms and Abbreviations

BEEPS	World Bank Business Environment and Enterprise Performance Survey
DPL	Development Policy Loan
DTIDZ	Directorate of Technological Industrial Development Zones
EC	European Commission
EP RVC	European periphery automotive regional value chain
EU	European Union
FDI	Foreign Direct Investment
FITD	Fund for Innovation and Technological Development
FYR	former Yugoslav Republic
GDP	gross domestic product
GVCs	global value chains
OECD	Organization for Economic Cooperation and Development
SEE	Southeast Europe
TIDZs	Technological Industrial Development Zones

All dollar amounts are U.S. dollars unless otherwise indicated.

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Foreword

Over the last two decades, successive governments and business leaders in the former Yugoslav Republic of (FYR) Macedonia have been actively working to transform the country's economy and put it on a higher, technology-based, growth trajectory. For a small, landlocked country with a limited domestic market and a weak industrial base, this requires building a private sector that is competitive, export-oriented, and integrated into global value chains (GVCs). In FYR Macedonia, where 23.7 percent of the labor force is unemployed and 30.7 percent of the population lives on less than US$5 a day (2016 data), creating an attractive, competitive, and export-oriented private sector—one that leverages the country's proximity to developed European markets and world-class enterprises—has become a political and strategic economic objective of the highest priority.

This report describes the parameters of an aggressive reform and investment promotion effort in FYR Macedonia that began a decade ago and moved the country's manufacturing sector toward higher value-added, technology-based production with a unique focus on automotive component manufacturing. Readers interested in learning how a small country located in the Balkans region with a-priori low potential was able to reform its institutions, promote itself, and attract foreign direct investment (FDI) should find it useful. So will readers that are interested in industry specific strategies that go beyond first generation business environment reforms. Much of the report is a look backwards, to describe the parameters of the program, how it was executed, and results that were achieved. However, future steps are also proposed. The program is still very much a work in progress, and while very real and significant gains have been made—much to the credit of the country—certain aspects of it could be improved. Parts of the program are also in the process of being reshaped to reach new objectives, many of them related to sustainability. How well the government of FYR Macedonia focuses on new objectives defined by this transitional shift and directs future resources to encourage the processes there to go forward, will be a determining factor in whether its companies, and the country as whole, will be able to take the economy to a new level of competitiveness.

Executive Summary

Since 1994, FYR Macedonia has been pursuing a comprehensive economic stabilization and development program with European Union (EU) accession as the anchor of reforms. With this effort, the country made significant progress in achieving macro-fiscal stability and greater openness to trade. Now, as a small, open economy that must find a niche in a fiercely competitive, globalized market, the focus of the strategy must be to improve the competitiveness of the private sector and increase exports in order to achieve long-term, sustainable, economic growth and employment creation.

To foster private sector growth and job creation the, government of FYR Macedonia developed and implemented a reform and investment promotion strategy designed to attract foreign direct investment (FDI) in higher-value added manufacturing. It was a two-pronged initiative that set out to:

- **Improve the business environment**. Since the mid-2000s, a series of business environment reforms were made that served as the foundation of FYR Macedonia's overall growth agenda. These included both horizontal measures, such as changes to institutions and labor laws, and vertical initiatives that reached down to touch specific sectors. Within a relatively short timeframe the reforms positively impacted the overall investment climate in the country, and also attracted considerable attention from international agencies that monitor that kind of activity. The long-term commitment made at the highest levels of government to the goals, strategy, and execution of the program was seen by many as the differentiating factor that contributed most to its success.

- **Attract FDI in key value-adding sectors.** Recognizing early on that the country was not an ideal destination for greenfield FDI, the government of FYR Macedonia developed and executed a proactive investment attraction strategy that offered investors a generous package of investment incentives and ready access to industrial infrastructure in newly created Technological Industrial Development Zones (TIDZs). This strategy was supported by a dedicated institutional structure and a robust national marketing campaign. The country distinguished itself with the commitment of its government to the goals of the strategy and the level of service it offered to investors. The investment attraction effort was complemented in 2010 by incorporating an export promotion mandate, particularly to leverage competitive advantages and strengthen local exporters' capabilities.

The strategy and its implementation have been successful in attracting investment to the automotive sector. By following the FDI promotion and export promotion strategy and actively leveraging legacy capabilities in the manufacturing and assembly of automotive parts, FYR Macedonia has emerged as a destination for highly sought-after foreign direct investment by automotive enterprises from Organization for Economic Cooperation and Development (OECD) countries. Today FYR Macedonia is a recognized, potential hub for automotive component production and bus manufacturing within the European periphery automotive regional value chain (EP RVC).

FDI in the automotive sector has had a significant impact on FYR Macedonia's export profile and labor market. The country's total merchandise exports increased by 7 percent from 2011 to 2016[1] at a time when traditional exports of metals and minerals dropped by 57 percent.[2] The export increase was driven largely by the automotive industry and associated sectors such as chemicals, machinery and electronics, plastics, and rubber. Correlated to those greater exports was a higher degree of technological sophistication and content. The government of FYR Macedonia's FDI attraction efforts have also resulted in the creation of thousands of jobs (both inside and outside the DITZs) in new, export-oriented

1 Source: UN Comtrade.

2 Source: UN Comtrade. Exports of metals and minerals include those in HS chapters 26, 27, 28, 72, 73, 74, 75, 76, 78, 79, 80, and 81.

industries, particularly in automotive components. Although more detailed analysis is necessary, and questions remain about the quality of new jobs being created in terms of their wage potential, available data suggests that the expansion of the manufacturing sector has led to some transformations in the labor market, namely providing more opportunities for women, youth, and technical workers.

After 10 years of an overall successful approach, it is now an opportune time for political and business leaders to take stock of the program in light of identified challenges and unaddressed issues. These challenges and issues include sustainability, the evolution of competitive forces globally, and aspects of the business climate and investment promotion effort that could still be improved.

The government's approach is being criticized in the current economic and political environment. Pressure on government revenues, questions about the transparency of state aid, and some concerns about a perceived disparity of treatment between foreign and domestic companies have increased political scrutiny of FDI incentives. It would be useful to conduct a cost-benefit analysis and transparent assessment of the impact of these incentives on investors' decision making, as well as detailed feasibility studies when new TIDZs are proposed. Furthermore, low costs (particularly low labor costs that have been one of the most attractive for FDI), may erode in the future. As these advantages diminish, the country's future competitiveness will be seriously challenged at a time when both poverty and unemployment levels still must be addressed. The unemployment rate has declined slightly, but it still remains high compared to peers at 23.7 percent in 2016 (down from 28 percent in 2014), and the poverty rate, defined at incomes of US$5 per day or less, is 30.7 percent in 2016.[3] Public efforts must therefore continue to be available and directed in ways that increase general standards of living and foster private sector-led growth. Further, the country risks a decline in FDI inflows. FDI inflows dropped in 2014 (14 percent lower than in 2013) and were below average in 2015 (3 percent growth from 2014), although they increased again in 2016.[4] A stable and predictable policy environment will be important to enabling the country to remain a competitive destination for FDI.

A conducive business environment and further investment to address the lack of competitiveness and international experience of local firms, particularly small and medium enterprises (SMEs), will also be critical for a sustainable growth of the private sector and the economy overall. A business environment supportive of growth of local SMEs, and investment in linkages with foreign firms within the country and abroad, as well as a robust foundation of skills, innovation capacity, and adoption of more advanced technologies, are all important building blocks in FYR Macedonia's growth strategy going forward.

Ultimately, FYR Macedonia's experience demonstrates how attracting FDI can help local firms integrate into global value chains (GVCs) and create jobs, but those steps alone are unlikely to generate all the expected benefits to the local economy. Persistent challenges remain when it comes to integrating domestic companies into GVCs, improving their skills, facilitating growth of supporting industries, and fostering innovation among firms. The success factors outlined in this report are important for countries that wish to pursue a similar FDI attraction strategy, and also shows that the competitiveness of domestic industries and firms should be approached in a multifaceted way in order to ensure they achieve their full potential in contributing to economic and job growth. Additional initiatives and tools will generally be needed to maximize job creation and reap the full potential benefits that FDI can bestow on firms in the domestic economy. Figure 1 below summarizes the pending challenges that this report identifies and the recommendations to address them.

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3 Using the World Bank standard of US$5 a day (2005 PPP), poverty has fallen from 33.6 percent in 2014 to 30.7 percent in 2016. Furthermore, according to the income-based *Survey of Income and Living Conditions*, the proportion of severely materially deprived persons stands at 37.7 percent.

4 See Figure 5 for detailed figures.

Figure 1: Summary of Pending Challenges and Proposed Actions

AREA	CHALLENGES	RECOMMENDATIONS
Improve on Past Reforms	• Challenges in the business climate, particularly for local firms, persist. • Organizational inefficiencies remain in the FDI attraction system.	• Deepen reforms and improve implementation of laws and regulations, focusing on practicability, transparency, and the practical impact on firms. • Improve the quality and structure of public-private dialogue, particularly for domestic firms. • Rationalize the institutional structure for FDI promotion and strengthen coordination between agencies and the private sector to ensure more effective use of public resources.
Address Challenges to FDI Promotion Going Forward	• Fiscal pressures are emerging, particularly related to the cost (and effectiveness) of investment incentives. • Labor cost advantages can eventually erode in the competitive global context. • Investors may now perceive the country as having higher political risk than in previous periods .	• Test viability of new zones, by assessing economic feasibility as well as presence of enabling factors. • Conduct cost-benefit analysis of the incentive package provided to investors, including assessing the impact of the FDI program on job creation, and ensure applicable rules on state aid are followed. • Invest in fundamentals, such as labor skills, to continue attracting FDI. • Ensure a stable and predictable policy environment, including through business environment measures above.
Foster the Growth of Domestic Enterprises	• Fragmented support and insufficiently conducive environment for local enterprises (SMEs) to grow and invest in innovation, linkages, and exports. • There is uncertainty about whether benefits of FDI are spilling over into the local economy.	• Support investment in skills, innovation, and technology transfer. • Support investments in linkages between foreign and local firms, (e.g., anchor and scale up supplier development program). • Deepen efforts to promote exports of domestic products. • Further articulate the government's SME development and export promotion strategies and priorities. • Address non-tariff barriers in trade and regional trade cooperation.

1 Context for the Reform Program

Since 1994, FYR Macedonia has been implementing a comprehensive economic reform program designed to promote macroeconomic stability, regional economic integration, and private sector development as a way to boost growth and create jobs. Since its inception, the program has been supported by loans, technical expertise, and other forms of assistance from the donor community.

Accession to the European Union (EU) is anchoring much of the reform agenda. FYR Macedonia first became an EU Candidate country in 2005. Since 2009 the European Commission (EC) has been recommending opening accession negotiations, but the decision continues to be postponed, due in part to the longstanding name dispute with Greece. The 2015 EU Progress Report noted backward movement in important areas including the rule of law.[5] Nevertheless, the EC has an active and robust program of assistance to the country of FYR Macedonia, through the Instrument for Pre-Accession Assistance (IPA) I and II, both of which continue to be the largest sources of concessional funds in the country. All major political parties and over 80 percent of the population continue to support EU membership.[6]

Macroeconomic stability has been achieved, but recent years have shown a host of rising economic pressures. An exchange rate peg to the euro, introduced in 1995, has successfully supported price stability over the years, with inflation averaging roughly 1.7 percent between 2004 and 2016. Macroeconomic policies have also been focused on keeping the external balance manageable, and monetary policy has been responsive to possible threats to the peg. By 2008, as a result of prudent fiscal policies, gross central government debt fell from almost 50 percent of gross domestic product (GDP) in the early 2000s to 21 percent, and the country entered the financial crisis with one of the lowest public debt levels among developing countries in Europe. Nevertheless, expansionary fiscal policy since 2009 resulted in an average deficit level of 2.9 percent of GDP.[7] Repeated increases in pensions, wages, social benefits and subsidies increased pressures on the expenditure side, which, coupled with declining revenues, resulted in higher deficit levels in recent years. As a result, public and publicly guaranteed debt has risen sharply, reaching 46 percent of GDP in 2015 and 47.7 percent of GDP at the end of 2016.

The country is fully open for business and reaping substantial gains from increased international trade. With a trade openness index of 113 percent in 2016,[8] FYR Macedonia is now considered the most open among the countries of Southeast Europe (SEE), and almost 40 percent more open than developing countries in the Europe and Central Asia (ECA) region.[9] After becoming a member of the World Trade Organization (WTO) in 2003, and a candidate country for EU membership in 2005, FYR Macedonia signed a number of important regional and bilateral agreements, including the Central European Free Trade Agreement (CEFTA) in 2006, that enhanced intraregional trade between Balkan countries by effectively replacing 32 bilateral agreements that had previously existed among them.[10] As a result, trade with the EU increased dramatically since the early 2000s; it grew by 265 percent for imports from the EU and 525 percent for exports to the EU between 2001 and 2014. Thus, trade liberalization coupled with the close proximity of the country to EU markets certainly had a role to play in the decisions of foreign firms to locate their investments in FYR Macedonia. Many of the large investors that came to the country are manufacturing firms who target consumers in EU markets.

Despite these achievements, more efforts are needed to generate and sustain the kind of economic growth that creates jobs and improves living standards for all. Following strong economic growth during the period 2002–08 that averaged roughly 4.3 percent, GDP growth in FYR Macedonia has declined to an average of 2.2 percent per year since 2009. The country’s growth trajectory shows a mix of positive (more sustainable) and negative (less sustainable) aspects. The

5 European Commission. “Commission Staff Working Document: The Former Yugoslav Republic of Macedonia Report 2015.” Brussels, November.

6 According to the World Bank Group Country Partnership Strategy for the Former Yugoslav Republic of Macedonia, fiscal 2015–18.

7 This is the average fiscal deficit during the period 2009–16.

8 A World Bank World Development indicator representing the sum of imports and exports relative to GDP.

9 SEE includes Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia.

ECA includes Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Georgia, Kazakhstan, Kosovo, Kyrgyz Republic, FYR Macedonia, Moldova, Montenegro, Romania, Serbia, Tajikistan, Turkey, Turkmenistan, Ukraine and Uzbekistan.

10 As of January 2016, the parties of the CEFTA agreement are: Albania, Bosnia and Herzegovina, FYR Macedonia, Moldova, Montenegro, Serbia and the United Nations Interim Administration Mission in Kosovo (UNMIK) on behalf of Kosovo. Former signatories that left upon becoming EU members are Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia.

country was able to avoid negative growth following the 2008 global crisis—a substantial achievement—and during 2010-2014, investment was the main driver of growth. While this reflects important growth in private investment, it also includes substantial public investment in the Skopje 2014 project in the capital of the same name. In 2015, investment flows dried up, and consumption increased substantially. At the same time, other countries in the SEE region are moving towards more sustainable growth models, with a decreasing share of consumption. For living standards to converge to those enjoyed by new EU member states, real GDP growth needs to accelerate back to around 4.5 percent within the next 20 years. While GDP growth seems to be recovering (2.4 percent in 2016 and expected to be 2.8 percent in 2017), the recovery is driven by rising consumption and higher public spending instead of investment, which calls into question the sustainability of the trend. Furthermore, the country still lags behind the EU-10[11] in terms of exports as a percentage of GDP, highlighting that there is still room for improvement.

The main drivers of growth since 2009 have been manufacturing and construction. The growth in manufacturing was largely driven by FDI, which averaged 3.8 percent of GDP per year between 2006 and 2016, and FDI contributed to increased diversification of FYR Macedonia's export basket both in terms of products and destinations and increased technological intensity. The contributions of agriculture and public administration to GDP growth declined 2009–16.

The rate of unemployment, which remained stubbornly high through the mid-2000s, started declining in the second half of the decade—falling from a high of 38 percent in 2004 to 23.7 percent in 2016. In fact, FYR Macedonia holds the distinction of being the only SEE[12] country where unemployment declined in the post-crisis period, but its unemployment rate is still the second highest among SEE countries. Despite some improvement in youth unemployment, it still remains one of the highest in the region at 48 percent. Long-term unemployment remains a problem; the long-term unemployment rate was 81.5 percent in 2015 and 2016.[13] In addition, gender inequalities are prevalent and female labor force participation (for women aged 15–64[14]) remains low at 51 percent, well below the regional average of 62 percent.

Improvements in the employment rate have translated into poverty reduction in recent years, though the country still presents higher poverty rates than regional peers. The increases in employment have particularly benefitted the bottom of the income distribution. Using a poverty line of US$5 per day in 2011 purchasing power parity (PPP), estimates of monetary poverty show a considerable decrease, moving from 35 percent in 2009 to 25 percent in 2014. As employment has continued to grow in more recent years, poverty is expected to have reduced further, though the sizable influence from public sector employment and public stimulus raises concerns about the sustainability of this decreasing trend.[15] Poverty is still, however, higher than in other countries in the region at similar levels of development, such as Serbia (10 percent in 2013) or Bulgaria (11 percent in 2012). Extreme poverty, measured using the global poverty line of US$1.9 per day in 2011 PPP, is low in the country and affected roughly 5 percent of the population in 2014. Non-monetary poverty is also higher than in other countries in the region. The proportion of severely materially deprived persons stood at 30

11 The EU-10 countries are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

12Refers to six Southeast European countries (SEE): Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia

13 According to the Labor Force Survey.

14 This uses the international classification for labor data. The legal working age in FYR Macedonia is 18.

15 World Bank. 2017. "Poverty reduction, shared prosperity and inequality in FYR Macedonia in the post financial crisis period (2009-2013)." Washington, D.C.: World Bank. See: https://hubs.worldbank.org/docs/imagebank/pages/docprofile.aspx?nodeid=27423198

percent in 2015.[16] This is higher than any other country in the EU region (except by Bulgaria), and almost four times higher than the EU-28 average.

As a small, open economy, FYR Macedonia needs to rely on further growth in exports and increased competitiveness to answer its long-term growth challenge. Despite the progress made in attracting export-oriented FDI, the ability for local SMEs to integrate more deeply into international markets is limited by their relatively low managerial, financial, and technical capacity. Continued efforts to improve competitiveness are particularly important given the country's exchange rate peg to the euro. Additional efforts to boost growth by facilitating business expansion and linkages, strengthening the investment climate, supporting innovation, and further developing services will help the country foster sustained private sector-led growth.

16 Eurostat defined as severely materially deprived people those who have living conditions greatly constrained by a lack of resources and who cannot afford at least four of the following: to pay rent or utility bills; to keep their home adequately warm; to pay unexpected expenses; to eat meat, fish, or a protein equivalent every second day; a week holiday away from home; a car; a washing machine; a color TV; or a telephone.

2 Reform and Investment Promotion Strategy

Starting in the mid-2000s, the Government responded to the challenges of developing new sources of growth by adopting a two-pronged strategic approach: the first set of measures aimed to improve the business environment and the second focused on attracting FDI in key value-adding sectors. In July 2006, a new coalition government assumed office with an election program, *Rebirth in 100 Steps,* that set ambitious reform objectives for economic growth. One of the goals cited in that document, "to increase economic growth and competitiveness to generate higher rates of employment and improved living standards," provided the main impetus for the reform program.[17]

The government recognized the importance of developing and reforming institutions as an established approach for increasing investments and accelerating economic growth. The prospects of EU accession served as a catalyst for institutional reforms, requiring an alignment of the country's laws with the European *acquis*[18] and improvement in institutional capacity. Domestically, the private sector was also in need of regulatory stability and a more favorable business environment. According to the *2005 World Bank – Enterprise Surveys*,[19] areas such as tax rates and administration, access and cost of financing, violations of contracts, uncertainty about regulatory policies, and business licensing and permits, were identified as major obstacles for an overwhelming majority of the business community in FYR Macedonia.[20] International institutions such as the World Economic Forum and World Bank specifically cited the business environment as an area in dire need of improvement.

Policy-makers understood that enhancing the ability to bring FDI into the country would be fundamental to attaining the growth objectives set out in key strategies.[21] Fully aware that the country lacked a globally competitive domestic private sector and jobs, the government of FYR Macedonia focused on attracting FDI because investments by foreign exporting firms have the potential to create linkages with local producers and promote integration of the domestic tradable goods sector into global supply chains, generating technological and managerial spill-overs that support sustainable growth. For these reasons, attracting FDI and building up export capacities has been the linchpin of the authorities' economic policy over the last decade.

2.1 Business Environment Reforms

The program for business environment reforms that began in the mid-2000s included the following goals and set of reform measures:

- **Reducing the burden of superfluous business regulations** by introducing a guillotine process for existing regulations[22] and requiring an impact assessment for new regulations.
- **Reducing the processing time** to register a business.

17 World Bank Group Country Partnership Strategy for the Former Yugoslav Republic of Macedonia, fiscal year 2011–14.

18 The *acquis* is the body of common rights and obligations that is binding on all the EU member states. It comprises treaties, legislation, declarations and resolutions, international agreements, and others. It can be understood as "EU law." See: http://ec.europa.eu/enlargement/policy/glossary/terms/acquis_en.htm

19 World Bank 2006.

20 Between 45-60 percent of respondents viewed these categories as an obstacle.

21 Southeast Europe 2020 Strategy, Industrial Policy Strategy 2009-2020, Employment Strategy, Export Promotion Strategy, etc.

22 A term that refers to the elimination of unnecessary bureaucratic regulatory practices.

- **Completing the land cadaster** and real estate registry.
- **Strengthening the financial system** and financial system regulation.
- **Further increasing labor** market flexibility.
- **Protecting ownership rights,** contract enforcement, and shareholders' rights.[23]

Several of these reforms were supported by European institutions (particularly the EU and the British Embassy) and World Bank programs.

A number of sector-specific reforms were also initiated. Sector competitiveness assessments supported by the World Bank were conducted and finalized in 2012 to inform the analysis of business environment constraints. Based on findings and key priorities, a Programmatic Competitiveness Development Policy Loan series was designed and financed by the World Bank with the following sector-specific objectives:

- **Manufacturing**: Developing high value added manufacturing by further developing and implementing exporter support programs, enhancing private sector representation in the governance of key institutions, and improving assessment and monitoring mechanisms for state aid granted through TIDZs.
- **Agriculture:** Facilitating the restructuring of the agribusiness sector through improvements in administration of state-owned land, and the reorientation of the public resources available to agriculture producers in ways that promote upgrading and long-term investments.
- **Trade logistics**: Improving the efficiency of inspections at border crossings and increasing the export-readiness of the transport industry.
- **Labor laws and Innovation**: Creating enabling conditions for labor market flexibility and innovation capacity by improving incentives for formal work, addressing skills bottlenecks, and improving the public sector capacity and regulatory framework to nurture private sector innovation.

The implementation of reforms aimed at private sector and competitiveness development was supported by international institutions such as the World Bank Group, and, in the area of export promotion by the U.S. Agency for International Development (USAID).

2.1.1 Institutional Structure for Implementing Reforms

The highest levels of government took responsibility for carrying out the business environment reform agenda. In an effort to approach the reforms in a consistent and organized manner, the government of FYR Macedonia established an inter-ministerial Committee for Regulatory Reforms in 2006 that was chaired by the Deputy Prime Minister and charged with managing the agenda for regulatory reform. A dedicated team within the Ministry of Finance was assigned to support this committee, and achieving improvements on the World Bank Group's *Doing Business* indicators[24] became a primary focus of its reform agenda. The team studied the methodology behind each indicator, identified which areas should be prioritized, provided the information to the Committee, and followed up with the World Bank Group *Doing Business* team annually.

A consistent theme across many of the reforms was the introduction of modern information technology (IT) and the placement of government functions online to provide more efficient and transparent delivery of services to the private sector. This was done primarily through an eGovernment Project that lasted from 2004 to 2011. First, a series of laws were adopted between 2001 and 2009 aimed

23 World Bank Country Partnership Strategy, fiscal 2007–10.

24 *Doing Business* is a flagship publication by the World Bank Group, which provides objective measures of business regulations for firms around the world.

at codifying the validity of e-signatures, defining the parameters of e-commerce, strengthening data protection, and improving other areas related to providing a solid foundation for the electronic delivery of government services. Then, the eGovernment Project helped facilitate the development of pilot IT applications and a portal to provide a single point of access to government information and services.[25] Electronic services became available in such areas as taxes, business registration, obtaining of various licenses and quotas, land registration, and management of court cases.

Several organizational bodies at the central level are key avenues for public-private dialogue shaping reforms, regulatory changes, and monitoring their progress. The key bodies are as follows:

- **Economic Council:** Chaired by the Prime Minister and composed of key government agencies and foreign investors, the Economic Council discusses foreign investments and policies to attract FDI, while offering investors an avenue to voice regulatory and operational concerns.
- **Competitiveness and Innovation Council**: Chaired by the Deputy Prime Minister for Economic Affairs, the Competitiveness and Innovation Council reviews strategic documents, such as a competitiveness master plan, and a strategy and action plan. It reviews the activities of the Innovation Fund and the suitability of various financing instruments. It also provides a forum for discussing other issues related to competitiveness, such as the state of research and development in the country. Representatives of academia and private sector participate in this council.
- **FDI Committee**: The FDI Committee is a public sector entity made up of all institutions involved in investment promotion and attraction that helps manage communications between potential investors and high-level policy makers. The committee routinely discusses pipeline projects and reports constraints to attracting and specific investments being materialized to the Prime Minister and the key ministers in charge.

Box 1: The Economic Council

The Economic Council, established in 2013, brings together the government and foreign investors on a regular basis. Initially it was created as a platform to systematically address the challenges faced by foreign investors in the TIDZs, but more recently it was expanded to include foreign firms outside of the TIDZs, as well as non-manufacturing firms. Companies that are members provide the council with a list of problems they are facing so that the government of FYR Macedonia can get a better handle on the issues involved and hopefully resolve matters.

The body is also responsible for helping to identify and eliminate business environment bottlenecks that might be affecting efficient operation of the businesses.

The Council also provides a learning environment for the government. According to the CEO of the Directorate of Technological Industrial Development Zones (DTIDZ), foreign companies often share best practices from around the world in committee sessions, and in doing so, help improve the overall system for all firms. For example, it was in this context that FDI led to changes in visa and work permits that facilitated the employment of foreign citizens and allowed companies to address skills gaps in the short and medium term.

25 The eGovernment Project was implemented by USAID. See: uslugi.gov.mk

The private sector and their associations have also been involved in higher level organizations to engage in advocacy and dialogue with the government. Those bodies include:

- **National Entrepreneurship and Competitiveness Council**: A tripartite body, aimed at strengthening the dialogue between the public sector, private sector, and civil society, and developing policies to increase competitiveness and domestic and foreign investment (among other goals). This council was established jointly by representatives of the public and private sectors.
- **Foreign Investors Council.** A group within the Economic Chamber of Macedonia that provides a forum for member companies to raise and discuss economic issues among themselves and bring issues to the attention of the government.

Some members of the private sector allege that the public-private dialogue is overly geared to address the concerns of foreign investors. The concern is that foreign firms, particularly those in the TIDZs, have direct access to discuss and resolve their concerns through the Economic Council, while other firms do not have similar avenues. Deliberations or consultations outside of the framework of the council are limited, even those pertaining to informing the private sector of upcoming or planned changes in laws and regulations.[26]

2.1.2 Reform Outcomes

International institutions and the EU have acknowledged the positive results of FYR Macedonia's institutional and business environment reform program. On the World Economic Forum's Global Competitiveness Index, the country improved from a ranking of 85 out of 117 economies in 2005 to 60 out of 140 economies in 2015; however, it fell to 68 out of 138 economies in 2016.[27] [28] The European Bank for Reconstruction and Development (EBRD) in its 2013 *Assessment of Commercial Laws in FYR Macedonia* also noted that the country "has made some good progress over the past few years in bringing its legal and regulatory framework in line with the modern standards." Furthermore, in looking at the World Bank Group's *Doing Business* indicators, the country improved 69 places between 2004 and 2015, from a ranking of 81 out of 155 economies in 2004, to a remarkable 10 (out of 190 economies in 2017.[29] FYR Macedonia was recognized as one of the top 10 countries among those that improved the most in three or more areas as measured by the *Doing Business* methodology in 2008, 2009, 2010, 2012 and 2014; and in a feature of the *Doing Business* 2013 report, the country was highlighted as the fifth-most improved country in narrowing the "distance to the frontier" since 2005.[30] The areas of *Doing Business* in

26 The project "Learning from the Business Community," led by the Cabinet of the Deputy Prime Minister for Economic Affairs, aims to meet and discuss business environment issues with SMEs. While this initiative is useful, it does not have the characteristics of a public-private dialogue platform with broad representation of the private sector where enterprises can raise their needs and government can consult on proposed new or changes to laws and regulations on a regular basis.

27 Data comes from the Global Competitiveness Report 2005, 2015–16, and 2016–17. Calculation of the rank is not adjusted to reflect any methodology changes that might have taken place since the first report publication, and is taken from the printed version of the report.

28 Examining the 10 sub-indicators that make up a country's total score, in 2016 FYR Macedonia exhibited declines on seven indicators and slight increases in three. The largest decline was an 11 percent reduction in the country's score for higher education and training. This is consistent with feedback from the private sector on insufficient skills of the workforce for aspects of higher-value added production (manufacturing) and services (e.g., tourism).

29 Comparisons of the rankings in this chapter are not back-calculated to adjust for the changes in *Doing Business* methodology and addition of new economies. It is done based on the ranking assigned to the economy in the printed *Doing Business* publications. Only the difference for the ranking assigned in *Doing Business* 2017 and *Doing Business* 2016 is available at www.doingbusiness.org as a back-calculated value, therefore adjusted for the changes in the methodology that the report has recently implemented.

30 The "Distance to Frontier" metric represents the best performance observed on each of the indicators across all economies in the *Doing Business* sample since 2005.

which FYR Macedonia implemented the greatest number of reforms were: starting a business, paying taxes, and getting credit.[31]

While targeted efforts to improve aspects of the legal framework as measured by the annual *Doing Business* report have paid off, improvements in regulation do not always consistently translate into more efficient practices. For example, for the year 2013 *Doing Business* estimated that, according to regulations, obtaining a construction permit should take around 89 days in FYR Macedonia, yet the *World Bank – Enterprise Survey* showed that it takes on average 180 days. Similarly, *Doing Business* estimates showed that it takes less than a day for firms to clear imports and exports through customs while the *Enterprise Survey* showed 10.9 and 3.7 days respectively.[32]

Following on legal and regulatory reform, the next step for FYR Macedonia is to ensure positive impact on firms in practice. The business environment is more than laws and regulations, and, while useful to benchmark against other countries and measure progress over time, *Doing Business* reforms do not capture all that is needed to make a sustained difference in outcomes for firms. The 2013 evaluation of *Doing Business* by an independent review panel stated that the conditions in which firms operate in practice are very different from requirements and procedures on paper.[33] In FYR Macedonia, for example, frequent changes to the laws, the uncertainty they create and the associated compliance costs were cited by the private sector as an impediment to doing business. The government of FYR Macedonia is aware of those challenges and moving towards the effective implementation of regulations to bring expectations in line with practice, while identifying additional areas for improvement of the business environment that can positively benefit firms.

31 Details of the reforms in these areas is available in the *Doing Business* reports.

32 Data from www.doingbusiness.org and www.enterprisesurveys.org, from 2013 (latest *Enterprise Survey*).

33 Independent Panel Review of the Doing Business report, June 2013. It is useful to note that the *Doing Business* indicators do include elements that measure firms' experiences in practice; however, the need to make the ratings consistent across countries and some aspects of the methodology used may limit how well the indicators can capture the full extent of operating conditions for firms in one specific country. See: http://www.dbrpanel.org/sites/dbrpanel/files/doing-business-review-panel-report.pdf

Box 2: Success Factors for Doing Business Reforms in FYR Macedonia

Between 2004 and 2015, FYR Macedonia improved its *Doing Business* ranking by 69 places to a remarkable 12 out of 189 countries in 2015. The critical success factors included:

Political will: The reform agenda received support at the highest levels of government and an improved business environment was set as a goal for the Ministry of Economy. The Cabinet of the Deputy Prime Minister for Economic Affairs provided coordination to streamline the reform efforts, and the Ministries of Finance, Justice, Economy, and Transport and Communications joined initiatives for reforming the legal and regulatory framework.

Coordination capacity: In 2006 the government established an inter-ministerial committee for Regulatory Reforms. To support the committee, a dedicated team was assigned in the Cabinet of the Deputy Prime Minister for Economic Affairs, and the team was later transferred to the department for macroeconomic policies in the Ministry of Finance. The purpose of the committee was to: (i) identify areas to prioritize on the *Doing Business* reform agenda and provide relevant information to the Committee for Regulatory Reforms; (ii) study the methodologies behind the indicators and make sure that various relevant specialized departments and agencies understand them as well; (iii) monitor the progress of reform implementation by other relevant specialized departments; and (iv) engage with the private sector to collect feedback on the reforms and their impact. The team also proactively engaged the World Bank Group *Doing Business* team on a regular basis to provide updates on the progress in the country and seek clarifications on methodology when needed.

Strong collaboration among ministries at the operational level: As the government pushed for change, its efforts triggered multiple initiatives within ministries and agencies. For example, the Ministry of Transport and Communications initiated several legal reforms to simplify and speed up the process of obtaining a building permit. The Customs Administration introduced several measures to increase the speed and efficiency of trade. The National Bank helped strengthen the financial system by establishing a public credit registry in 2008.

Collaboration with the private sector. Private sector groups were also engaged in the implementation of some of the reforms. For example, as the result of an effort initiated by the Ministry of Finance, a private credit bureau was formed by the association of commercial banks and started operating in 2011.

Source: World Bank interviews from *Doing Business,* "Economy Case Studies: FYR Macedonia." 2012.

2.2 Investment Promotion

Since the early 2000s—recognizing that the country was not a destination of first choice for greenfield FDI—the government of FYR Macedonia embarked on a proactive investment promotion strategy, establishing a public program in 2003 to attract and support investment.[34] Implementation of the strategy proceeded in earnest from 2007 onward. The strategy met with positive

34Interviews with potential investors confirmed that FYR Macedonia was not an obvious investment destination choice given that it was competing with several other countries with larger labor and consumer markets, more central locations, and better infrastructure.

results as foreign firms invested in the country. In addition to access to the EU market and the investment-friendly environment (see business environment reforms discussed above), investors often cited government proactiveness and support, direct access to decision-makers (related to small size of the country), FDI incentives (including tax and other incentives), and access to low-cost skilled labor as the reasons for investing in FYR Macedonia.[35] How this FDI attraction strategy was composed and executed is discussed below.

2.2.1 Organization and Structure

From the very beginning, the government took steps to create an institutional structure that was charged with carrying out the investment attraction agenda. It included:

- **Agency for Foreign Investments (InvestMacedonia)**: InvestMacedonia, established in June 2004 by the "Law on Establishment of the Agency for Foreign Investment," is the primary institution tasked with attracting and supporting foreign direct investment. Initially launched with a staff of four, InvestMacedonia grew to more than 50 employees and managers, and played a key role in facilitating many investment deals, particularly those in the automotive sector. Its FDI attraction functions over time have included marketing (promoting the country through media campaigns and road shows), investor servicing (supporting prospective investors in the due diligence process and facilitating rapid start-up of operations), and investor aftercare (assisting existing foreign investors with visas, working permits, custom issues, policy advocacy, and linkages with domestic companies). In 2010, InvestMacedonia's mandate was expanded to include export promotion, and it was renamed as the **Agency for Foreign Investment and Export Promotion.** While InvestMacedonia has been a key player, its capacity and types of activities implemented have varied over time.
- **Directorate of Technological Industrial Development Zones (DTIDZ)**: DTIDZ was established in 2002 with the mandate of developing and servicing greenfield investments in Macedonia. The DTIDZ manages FYR Macedonia's special economic zones and takes an active role in investment promotion, particularly for the automotive components industry that is prominent within the zones.
- **Ministers without portfolio**: Over the years, four Ministers for FDI have been given responsibly for driving and executing a broad range of policies to secure business and investment opportunities in FYR Macedonia.
- ***Ad hoc* involvement of other actors**: Ambassadors and (more recently) various economic promoters under the Prime Minister's Office also engaged actively in investment promotion activities.

2.2.2 TIDZs and Incentive Packages

A cornerstone of the country's FDI attraction strategy is offering investors industrial infrastructure and incentives through its TIDZs. TIDZs are special economic zones first established in 2000 and managed by the Directorate. TIDZs are customs areas within the territory of FYR Macedonia where special customs and tax incentives prescribed by the Law on Technological and Industrial Development Zones are applied. Users of TIDZs can be any domestic or foreign entity registered in the country. TIDZs were established as free economic zones in 2000, under the "Law on Free Economic Zones" adopted in 1999. Until 2002, the Directorate overseeing them operated within the Ministry for Development. In 2007, the Law on Technological and Industrial Development Zones changed their name to TIDZs and established the Directorate of TIDZs.

35 Investor Survey report, InvestMacedonia 2009; Foreign Investor Perception Study for FYR Macedonia, Evalueserve 2011.

The TIDZs provide reliable infrastructure for investors to help them overcome physical barriers. Difficulties in gaining access to land and shortages of quality industrial infrastructure are addressed by the TIDZs. Investors in the zones have ready access to roads, electricity, water, high-bandwidth telecommunications network connections, central heating, lighting, fire safety systems, security monitoring systems, water, sewage and waste treatment plants, and gas pipeline hookups. Companies have to build their own facilities, but they benefit from the ability to secure a long-term land lease for a period of up to 99 years at symbolic prices. Subsidies of up to € 500,000 for construction costs are also available depending on the number of jobs to be created and the level of investments made.[36] The TDIZs provide investors with greater certainty, improved levels of service, and the ability to establish operations more quickly, lowering their overall risk.

The ready infrastructure is attractive, but by most measures it is the favorable tax policy applied within the TIDZs that attracts the attention of foreign firms. FYR Macedonia's TIDZs provide a corporate tax holiday of up to 10 years[37] and a broad range of benefits that include:

- No customs duties and VAT on imported equipment.[38]
- Zero percent personal income tax. Investors are not required to withhold the personal income tax (10 percent) from gross wages paid to their employees.
- Zero percent property tax.
- Zero percent excise taxes.
- A green customs channel at the border for expeditious export to EU countries and more efficient customs procedures as customs clearance (for import and export) in the zones.
- Grants for training and job creation.[39]

Although incentives such as these are widely used across the region as shown in Figure 2, in FYR Macedonia (last column on the right) these incentives come on top of a highly competitive wage environment and a stable currency exchange rate, which makes for a fairly attractive package.

Figure 2: FDI Incentives in Select European Countries[40]

	BiH	BGR	HRV	CZE	EST	H UN	LVA	LTU	SVN	POL	SRB	SVK	ROU	MKD
Cash grants/ incentives	X	-	X	X	X	X	X	X	X	X	X	X	X	X
Tax exemptions	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Property assistance/ other fiscal	–	X	X	X	X	X	X	X	X	X	X	–	NA	X

36 Exact prices could not be obtained by FEZ companies and are not reported by DTIDZ which reports them as 'symbolic.' The prices are published in the Official Gazette.

37 The exact duration of the incentives is determined by regulations regarding state aid, and may vary by company according to state aid intensity.

38 As per the " Law on Technological and Industrial Development Zones": "The equipment determined in Chapters 84, 85, 86, 87, 88, 89 and 90 of the Customs Tariffs and the spare parts thereof, which represents a foreign goods and which, as part of the investments of the user of the zone, is intended for performance of a business activity in the zone, shall not be subject to payment of import duties prescribed by the "Law on Customs Tariffs."

39 Such grants are not part of the standard package of incentives, but may be provided. The upper limit on the value of the package of investment incentives is set by *de minimis* rules on state aid.

40 Bosnia-Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Slovenia, Poland, Serbia, Slovakia, Romania, Macedonia.

	BiH	BGR	HRV	CZE	EST	H UN	LVA	LTU	SVN	POL	SRB	SVK	ROU	MKD
Training/labor market	–	X	X	X	X	–	X	X	X	X	X	X	X	X
Guarantees/ low-cost finance	–	–	X	N.A	X	X	X	X	X	–	X	X	X	–
Target sectors	X	X	NA	X	X	X	X	X	X	X	X	X	X	X

Source: International Monetary Fund Country Report No. 15/243 citing FDI Intelligence, FDI Atlas.com, and national authorities. 2015. "The Former Yugoslav Republic of Macedonia: Selected Issues," September.

The government plans to establish a total of 15 zones in the country, eight of which are currently in operation. The largest zones in operation (as shown in Figure 2) are Skopje 1, Skopje 2, Stip, Kicevo, Prilep, Struga, Strumica, and Tetovo. Their occupancy rates vary from 11 percent to 58 percent. So far, the automotive sector has been the most successful in the TIDZs. Of the 17 active companies present in the zones, 13 are in the automotive sector and represent a total investment of € 450 million.[41]

Figure 3: TIDZs in FYR Macedonia

Source: DTIDZ.

2.2.3 Branding and Promotion

Creating an FYR Macedonia brand was deemed critical to the success of the investment promotion strategy. When the investment attraction program first started, FYR Macedonia was, at best, not even on the map of many global investors. At worst, it suffered from negative perceptions associated with historic instability in the Balkans. The government of FYR Macedonia therefore invested (and continues to invest) in building a country brand and deployed a sophisticated communication strategy to brand the

41 The other companies are in the electronics, mechanical equipment, rubber and other plastics, and industrial textile sectors with some of them being suppliers to automotive and other industries. Source: DITDZ.

country as an attractive destination for investors through the institutions discussed above. An array of investment promotion tools is now used to touch potential investors at every level, including:

- **Broad-based promotion carried out through media campaigns and roadshows**: An *Invest in Macedonia* media campaign was implemented in 2007–08 with the Davos issue of *The Economist* as shown in Figure 4. The campaign included print media in major publications (such as *The Wall Street Journal*, *The Financial Times*, and *The Economist*) that sought to create a visual identity for the country and communicate the incentives it offered. It also served as a vehicle to emphasize the country's performance on the reform agenda, such as becoming a top performer in the *Doing Business* survey, to raise its profile with investors. Current investors were engaged to provide testimonials, and firms such as Johnson Matthey (automotive), Johnson Controls (automotive), Knauf and Arcelor Mittal (mining), EVN (energy), and Telekom AD (telecom) gave positive statements that were used. The media campaign was expanded to online and television ads. At its height, the campaign reached 90 newspapers, in 36 countries worldwide, and 20 websites. In addition to the media campaign, InvestMacedonia and DTIDZ coordinated approximately 10 road shows and global events per year to showcase the country and present investment opportunities in meetings with representatives of global companies. These events have been regularly led by the Prime Minister, or the Deputy Prime Minister for Economic Affairs, and include the participation of key agencies and persons (Minister of Finance, DTIDZ, InvestMacedonia, Ministers for FDI), as well as private firms. Some of these events involved participation of international media, including the *Financial Times* and *Forbes*. In recent years, promotion campaigns (covering both investment attraction and tourism) have continued through television outlets, including CNN, Euronews, Eurosport, and the Travel Channel.

Figure 4: *Invest in Macedonia* **Campaign** Advertisements

Source: InvestMacedonia.

- **Industry specific outreach carried out through industry events and fairs**: DTIDZ participates in every major automotive event across the world, such as the Detroit Auto Show, with its own booth. DTIDZ also participates in major automotive conferences attended by C-suite executives and senior decision-makers, such as Automotive News World Congress, Automotive News Europe Congress, Automobilwoche Kongress, and OESA Annual Conference. In addition to managing the overall *Invest in Macedonia* media campaign, DTIDZ also uses more targeted advertising, particularly in automotive magazines, and invites automotive journalists to come to FYR Macedonia for more in-depth reporting.

- **Direct outreach and promotion efforts to firms**: Targeting potential investors directly, the Ministers for FDI, InvestMacedonia's economic promoters, and other individuals in government involved in investment promotion develop and maintain relationships with C-suite (e.g., CEO, CFO, etc.) and senior business decision-makers throughout Europe, the United States, and Asia, across many industries. InvestMacedonia also maintains a presence in target countries determined by the government through economic promoters. Today, InvestMacedonia is present in 17 countries worldwide, with a focus on North America (six economic promoters and one office in Detroit), Germany (five promoters), and the United Kingdom (three promoters) so as to better target and serve potential investors, including those from the automotive industry.

Marketing efforts have generally focused on firms with experience in Eastern Europe.[42] There are exceptions to this, such as Van Hool, for which the FYR Macedonia plant is the first investment outside of Belgium, but the prevailing sentiment among promoters is that knowledge of the region goes a long way to alleviate some of the negative perceptions that investors could have about the country. It also allows investors to make a favorable comparison between what FYR Macedonia offers with respect to certain factors, such as land acquisition costs or permit processing times, relative to the mix of incentives offered by other nearby potential destinations.

Considerable time, energy and resources have been invested in building a positive country brand, so any potential threats to it should be recognized and addressed. It takes considerable effort to build a positive reputation, and investor impressions are often quite fragile. Costly investments in branding can be eroded quickly from the most minor incident, so once a positive brand is achieved it should be intensely guarded. To many outside observers, the political controversies of 2015–16 and the publicity surrounding them projected an image of political instability that threatened to affect how the country is viewed by investors abroad, and could impact the economic growth agenda. The extended political crisis may have factored into the drop in private investment in 2015; net FDI flows grew 2.7 percent in the year, including capital outflows in May 2015 (the height of the political uncertainties in the country and the Greek crises) and later in September and November.[43] This came after a 14 percent year-on-year decrease in FDI flows in 2014. Special care must be taken to restore the positive image that the country is capable of projecting. Additionally, the migration crisis that has seen the Balkans become a major transit point for hundreds of thousands of refugees from war torn regions (such as Syria) seeking resettlement in the EU countries of northern Europe, may have negative repercussions on investor perspectives about the country. However, the migration issue is certainly not isolated to FYR Macedonia, as it is also affecting the entire region and large parts of the European continent as well.

2.2.4 Implementation of the Investment Attraction Program

Before launching its FDI attraction effort, the government of FYR Macedonia studied the experiences of other small countries that had implemented successful FDI attraction strategies, including Ireland and the Czech Republic. Officials used knowledge that had been accumulated over the years by the Investment Development Agency Ireland (IDA Ireland) to inform their model, and the Czech Invest model was also informative. Also, between 2006 and 2009, InvestMacedonia and the Ministry of Economy were awarded a project from the (now defunct) European Agency for Reconstruction (EAR) to help with capacity building, knowledge exchange, and development of business partnerships. With EU and United Kingdom funding from that project, policymakers drew on support from experienced investment promotion consultants to develop and implement an investment promotion strategy. The counsel provided recommendations on shaping investment climate development policy at the Ministry of

42 Interviews with government officials conducted in March 2016.

43 2016. *Southeast Europe Regular Economic Report No. 9: Rebalancing for Stronger Growth*. World Bank. April.

Economy and gave advice on how to enhance the competitiveness of the country as an investment location. They also studied which sectors and source countries represented the greatest potential and how to best implement direct marketing campaigns in those target source countries. Later, the engagement included training and capacity building of relevant agencies. Those sessions focused on ways that the information and research capacities of InvestMacedonia, could be enhanced, what the investor generation process should be, what kind of aftercare services should be provided, and how those services should be delivered.

The government of FYR Macedonia recognized and seized opportunities as they presented themselves early in the investment promotion campaign, and gathered information from successful projects to refine the investment attraction model and approach. Initial investments into the automotive components sector from Johnson Controls (U.S.) and Johnson Matthey (U.K.) played an important role in attracting subsequent investments from other large U.S. and European auto parts companies, and helped shape the development of the investment servicing and aftercare functions at InvestMacedonia.

Steps were taken to strengthen governance of the two specialized institutions charged with investment promotion (InvestMacedonia and DTIDZ) so as to improve the physical and financial management of the zones and the quality and delivery of the incentive packages. Some of the measures taken included:

- **InvestMacedonia adopted the Guidelines for Control, Assessment, and Monitoring of State Aid** to ensure that the incentives provided by this agency were aligned with EU regulations and national rules on state aid, and that their effectiveness in achieving economic goals could be properly assessed.
- **Legal amendments were adopted to improve the governance of DTIDZ** by strengthening its Managing Board with the addition of representatives of the private sector. Three out of seven board members are now from the private sector, which helps to create checks and balances in administration of the zones.
- **The government piloted new approaches to give the private sector a greater role** in direct management of the zones. The TIDZ in Tetovo, which was tendered out in 2013 to a consortium of private investors, stands as a prime example.
- **Following policy dialogue and technical assistance from the World Bank** on DTIDZ's investment promotion program from 2013 to 2015, DTIDZ developed an approach for assessing market demand as an input into decisions on establishing TIDZs. This approach includes taking into account the pipeline of future investors, the availability of labor (both technical and language skills), transport connectivity, and the quality of services to investors.
- **In cooperation with auditing and accounting experts, DTIDZ prepared** the "Manual on Determination of Eligible Investment Expenses and Monitoring of Obligations from State Aid Contracts," which was adopted by its managing board in 2016.
- **Finally, the government called on people with experience working in the private sector** and internationally to become involved as heads of institutions or Ministers in charge of attracting FDI. Investment attraction is a talent that often requires strong native language skills and a keen cultural understanding of how firms within the target country make decisions. Promoters also have to be aware of the wider industry dynamics at play.

While the institutional structure has delivered results, organizational inefficiencies remain in the system and some functions have yet to be institutionalized. Challenges include:

- **Organizational inefficiencies:** Responsibility for the agenda is split between many institutions, which has led to overlapping functions and duplication of efforts. From InvestMacedonia, DTIDZ, the four Ministers Without Portfolio for investment promotion, and various Ambassadors, to a recently-created department hosting 12 non-residential economic promoters under the Prime Minister's Office, all have been given some role in attracting investment, which has led to multiplicity in the facilitation and aftercare functions. In the early phases of the program there was no official division of coverage between the institutions, either regionally or by industry, which led to some confusion during execution. While the situation has improved somewhat since then, interviews with relevant private sector and government stakeholders and investors suggest that coordination between actors remains in many cases suboptimal. Information sharing is limited as each institution may view the others as competitors. A regional template is meant to define the geographic area of responsibility of each institution for investment promotion, but mapping decisions are still sometimes driven by political and personal considerations, causing the responsibility for countries, and even cities, to be split between multiple agencies.
- **Partially institutionalized functions**: Authority and control sometimes extend from individuals and not the organization itself. For example, when the CEO of InvestMacedonia moved to the DTIDZ in 2011, effective management of the media campaigns moved with him without a commensurate transfer of budgetary control. As a result, the DTIDZ now manages the media campaigns outside the promotion agency. As another example, the law defines which organization is responsible for the investor aftercare function—DTIDZ within the zones and InvestMacedonia outside of the zones. But in practice, aftercare is often based on long-term relationships of the firms with their original point of contact within the government. As a result, the Ministers for FDI often handle aftercare issues rather than redirect them to InvestMacedonia or the DTIDZ for what could potentially be better handling. Industry specialization has also not been fully institutionalized. It is unclear if inquiries are being properly screened and routed to a particular go-to person that has unique insight into a particular market or industry segment and the skills to negotiate and manage a complex sales process.

Recommendations to bring the investment promotion agenda under one umbrella to ensure a more rational and efficient use of state resources have been met with resistance due to political considerations.

3 Results of the Investment Attraction Program and its Contribution to the Effort to Integrate into Automotive Global Value Chains

Through the reform and investment promotion agenda, FYR Macedonia aimed to join the ranks of countries that have an important role in global manufacturing supply chains. The target sectors included export-oriented industries including agribusiness, textile and apparel, and automotive components. This section examines the results to date across sectors, with a particular focus on automotive components.

Some of the country's traditional light industries, such as textiles and food products, are important due to their size, but face challenges to attain substantially higher levels of competitiveness and growth. As of 2012, the textile and apparel industry had solidified its role as an important manufacturing sub-sector, accounting for 28 percent of total manufacturing employment and 14.5 percent of total manufacturing production. Agribusiness exports, too, have more than doubled in the previous five years.[44] Since then, performance in these industries has been mixed: exports of food products and textiles grew by 3.5 percent and 4.2 percent, respectively, between 2011 and 2014, but declined to below their 2011 levels in 2015 and 2016.[45]

In **agribusiness**, the government of FYR Macedonia, with World Bank support, made considerable efforts to reorient agricultural subsidies to encourage productivity-enhancing investments, but the transition legacy of fragmented landholdings and functional deficiencies in land markets continue to pose structural challenges that weaken the incentive to invest in the agribusiness sector.

In **textiles and apparel**, the country managed to cope with increasing global competition in the apparel industry, but faces serious vulnerabilities relating to a global shift toward suppliers that are able to provide more value-added services (such as materials sourcing and logistics), and declining wage competitiveness relative to other apparel exporters, particularly those in Asia. Countries like FYR Macedonia with textile producers that tend to focus on cut-make-trim (CMT) type of assembly soon find themselves in a commodity trap whereby price is the only differentiator in the market. The challenge for the country is to foster investment in high value-added segments and target FDI attraction strategies to companies that have niche CMT capabilities and are integrated into global supply chains (e.g., Johnson Controls has investment in a cut-and-trim plant for car seat upholstery in Stip).[46]

Where FYR Macedonia's investment promotion strategy has been quite successful is in the automotive components sector, new investment in automotive, estimated at € 235 million from 2010-2015, amounting to about 5.5 percent of total foreign investment, has brought about significant changes in the country's export structure. Automotive exports have expanded seven-fold in nominal terms over the period, reaching € 1.8 billion in 2016, constituting roughly 10.5 percent of GDP.[47] The country has clearly emerged as a destination for FDI in the automotive sector by Tier 1 and Tier 2 suppliers from OECD countries (see Box 3 below), and this has impacted export diversification, job creation, and further linked FYR Macedonia into global and regional value chains. The remainder of this section explores how the country achieved this growth and is currently positioned.

44 2012. *FYR Macedonia Sectoral Competitiveness Assessment*. World Bank.

45 UN Comtrade.

46 2012. *FYR Macedonia Sectoral Competitiveness Assessment*. World Bank.

47 2016. *Southeast Europe Regular Economic Report No. 9: Rebalancing for Stronger Growth*. World Bank. April.

3.1 Integration into the Automotive Global Value Chain

FYR Macedonia is progressively emerging as a potential hub for automotive components production and bus manufacturing within the European Periphery Regional Value Chain (EP RVC). Experts acknowledge that this has come about partially as a result of the government's proactive strategy to attract FDI in the automotive sector since 2006, and also due to the relatively efficient public administration and predictable business environment that the country offers to foreign direct investors, in comparison to other members of the EP RVC. Rising production and labor costs in Central and Eastern European (CEE) countries and increasing geopolitical instability in the North African, Middle Eastern, and post-Soviet sub-regions of the EP RVC have also played a role.

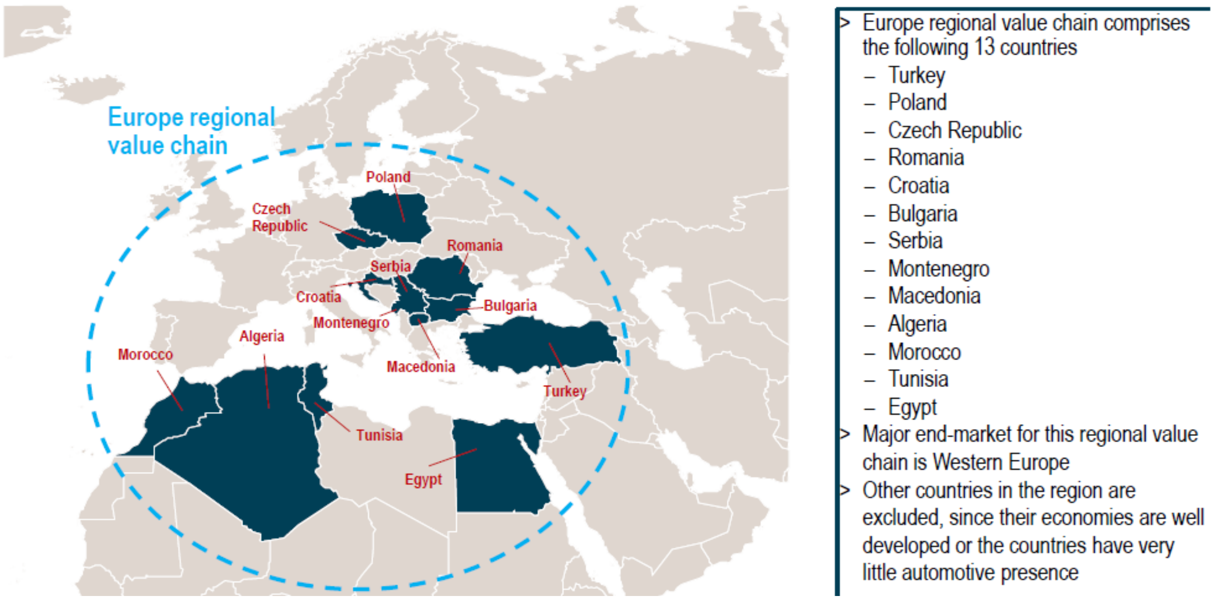
Box 3: The Automotive Global Value Chain — Definitions

A **global value chain** refers to an organization of production in which different stages of the production process are fragmented across countries**.**

The **automotive value chain** is organized in tiers on a global, regional, and local basis. Original equipment manufacturers (OEMs) are the assemblers and the final producer in manufacturing value chains (e.g., BMW, Mercedes). OEMs source inputs and services from Tier 1 firms, which are typically large companies that integrate and supply critical components. Tier 1 firms, in turn, source individual parts from Tier 2 companies. Tier 2 companies in some cases supply to OEMs directly and therefore can act as Tier 1s. Tier 3 companies are even smaller suppliers that serve the Tier 2s.

The **European Periphery Automotive Regional Value Chain (EP RVC)** includes approximately 13 countries in Central-Eastern and Southeast Europe, North Africa, and the Middle East (Figure 5). The main end-market for the EP RVC is Western Europe. The demand trends in this market, such as increased onboard electronics, high fuel-efficiency and environmental standards, onboard safety, and networked mobility, etc., influence the investment and sourcing decisions of the OEMs that the EP RVC feeds into.

Figure 5: Countries in the European Periphery Automotive Regional Value Chain



Source: Criscuolo, Alberto. 2015. "FYR Macedonia and the European Periphery Automotive Regional Value Chain, industry-specific global value chain analytics project." Washington, DC: World Bank.
Note: While Slovenia, Hungary, Ukraine, and Moldova may also participate in the value chain, the work cited highlights those shown in the figure.

Despite having a traditionally agricultural-based economy, FYR Macedonia was able to claim relevant engineering and manufacturing capabilities as a legacy member of the automotive component suppliers network for the Zastava plant in Serbia in the 1960s. Historically, the automotive industry has had a strong presence in the Western Balkans region. During the post-World War II period, vehicle assembly in Bosnia and Herzegovina and Serbia encouraged the emergence of a supply base for automotive components that included around 240 component suppliers across Yugoslavia.[48] One of the main legacies of that industry was a high level of automotive specific training and the availability of a strong skills base across the whole of the region that included metalworking, mechanical, and electrical engineering skills, welding, and plastics.

The availability of skilled labor influenced the decisions of foreign investors in the industry to locate in the Western Balkans relative to other emerging markets, over the past couple of decades.[49] The industrial restructuring of CEE since the 1990s has relied heavily on FDI, facilitated by privatization and the EU accession process. Foreign firms have brought capital, technology, know-how, and access to foreign markets, while benefiting from cost advantages and the skilled labor force of the local economy. Automotive has been a leading sector in industry restructuring in CEE, and one in which CEE has become a global production location.[50]

48 Sector Specific Sources of Competitiveness in the Western Balkans, OECD 2009.

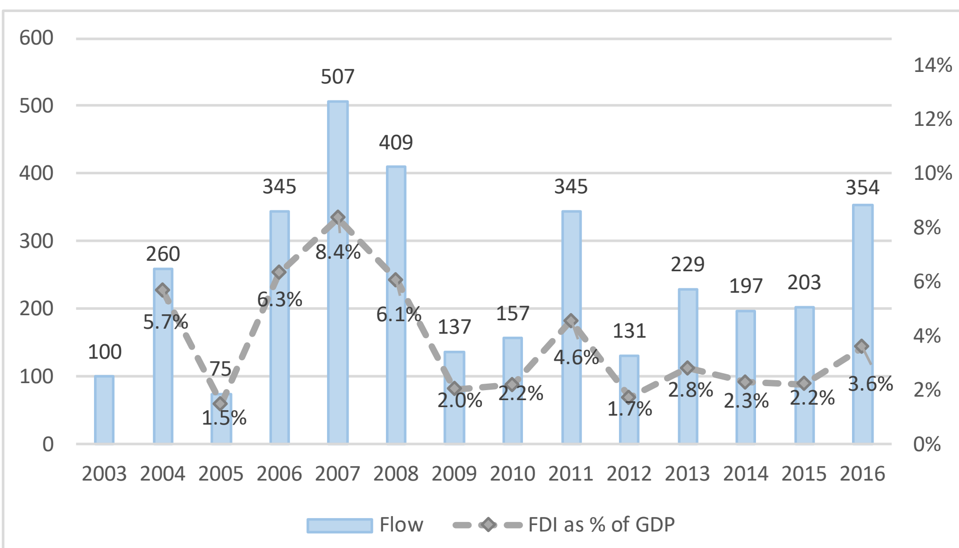
49 Sector Specific Sources of Competitiveness in the Western Balkans, OECD 2009.

50 Radosevic and Rozeik. 2005. *Foreign direct investment and Restructuring in the Automotive Industry in CEE.*

In spite of this history, the domestic automotive industry in FYR Macedonia in the years leading up to the reform and investment program was characterized by low technological development and a lack of export competitiveness. Although a number of state-owned companies remained, most local auto component companies were only formed in the beginning the 1990s, and they contributed little to export revenues and employment. The research and development (R&D) they conducted was also minimal both in terms of activity and number of employees.[51] For these reasons, planners concluded early on during strategy formulation that the local industry could not be counted on to provide impetus for growth in the near to medium term.

Early FDI in the late 2000s began to shift FYR Macedonia's automotive industry towards a modern, highly export-oriented production base that is integrated into global value chains. The government successfully attracted Tier 1 companies Johnson Controls (U.S.-based) and Johnson Matthey (United Kingdom-owned) to set up state-of-the-art manufacturing facilities at the 140-hectare Skopje 1 (Bundardzik) TIDZ located near the international airport. Johnson Controls opened a US$40 million plant there to produce electronic dashboard components in 2007, and Johnson Matthey opened a € 70 million emission control catalyst plant there in 2010, followed with a second investment of € 60 million.[52] Indeed, as of 2010, the major economic indicators of automotive-related industries in FYR Macedonia suggested that these two multinational Tier 1 companies were the key players of the automotive industry, accounting for approximately 82 percent of the US$206 million in revenue generated by the industry, with 96 percent of that revenue stemming from exports. Since then, major German, American, and, more recently, Belgian firms have started outsourcing the production of components for the automobile industry in FYR Macedonia's TIDZs, effectively replacing traditional trade partners, such as Kosovo, Bulgaria, and Serbia as the country's main export destinations. Net FDI flows (in all sectors; a positive number indicates inflow) are illustrated in the figure below.

Figure 6: Total Net Foreign Direct Investment Flows into FYR Macedonia, 2003–16 (€ millions)



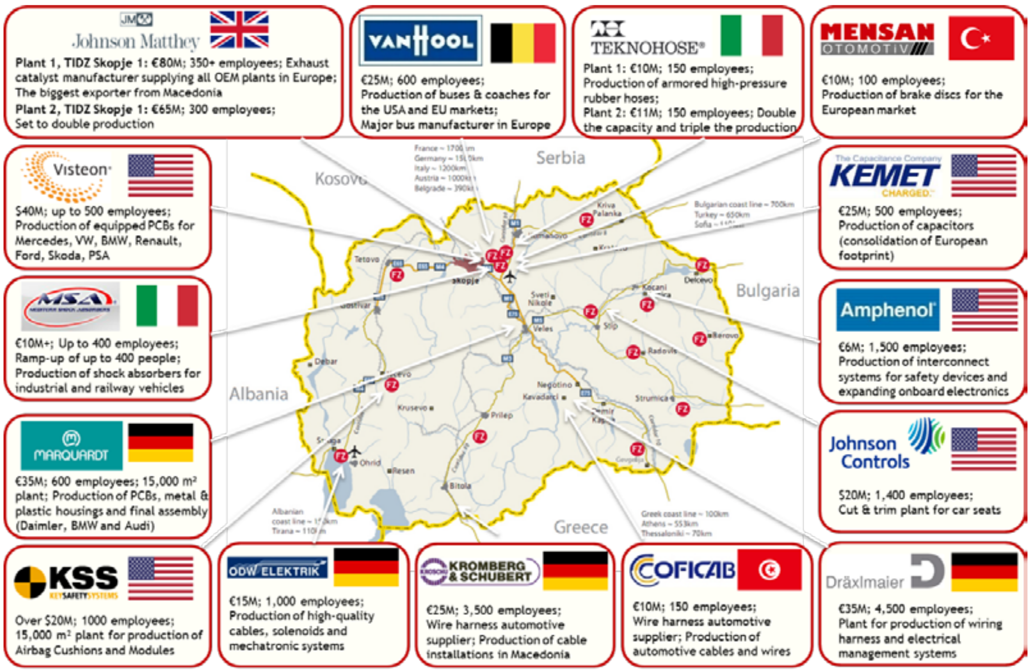
Source: National Bank of the Republic of Macedonia, "Balance of Payments data."
Note: All monetary amounts shown in euros.

51 2011. *FYR Macedonia Value Chain and Competitiveness Analysis: Garments and Autoparts*. Washington, DC: World Bank.

52 Source: DITDZ.

The influx of FDI in automotive has allowed FYR Macedonia to integrate into the European Periphery Regional Automotive Value Chain (EP RVC). FDI inflows relating to the automotive sector have more than doubled since 2011, increasing exports and creating jobs. At least 15 foreign investors in automotive have established manufacturing facilities in FYR Macedonia since 2007, and there has been a significant acceleration in deals over the past three years.[53] At least 10 are expected in 2016,[54] and as of 2012, foreign firms accounted for 52 percent of employment in the automotive sector.[55] Figure 7 illustrates the major investors and summarizes their activities.

Figure 7: Selected Foreign Direct Investors in FYR Macedonia's Automotive Sector



Source: DTIDZ.

Tier 1 and Tier 2 companies constitute the bulk of the multinationals that have set up operations in FYR Macedonia, with the notable exception of VanHool, a Belgian OEM motor coach manufacturer serving the European Union and United States markets. The foreign investors in automotive are fully integrated into the EP RVC, accounting for approximately 92 percent of the revenue generated by the automotive industry in FYR Macedonia and 96 percent of automotive exports.[56]

FYR Macedonia is now on the map of investment destinations for automotive components manufacturing, and the pipeline of Tier 1 and Tier 2 auto component investors is growing. According to the Central Bank and the State Statistical Office, FYR Macedonia attracted net inflows of € 503 million in FDI in the vehicles and transport equipment sector over the 2009–15 period, representing 85 percent of manufacturing FDI and 35 percent of all net FDI inflows into the economy during that time. Further, FDI in the automotive component manufacturing sector may not be limited only to transport equipment—some FDI may appear as textiles (e.g., upholstery), rubber (e.g., tires), and others. According to interviews with the DTIDZ and other publicly available information, the expected total FDI stock in the

53 Source: DTIDZ.

54 Top 10 Best Investments in FYR Macedonia for 2016.

55 2012. *FYR Macedonia Sectoral Competitiveness Assessment*. Washington, DC: World Bank.

56 Criscuolo, Alberto. 2015. "FYR Macedonia and the European Periphery Automotive Regional Value Chain, industry-specific global value chain analytics project." Washington, DC: World Bank.

TIDZs and in the two largest investors located outside of the zones (Draexlmaier and Kromberg & Schubert) is expected to reach around € 500 million by the end of their investment cycle.

Investment in TIDZs is generating exports and jobs. As of Q1 2016 the total number of employees in the zones was 5,400. Outside of the zones, the plants of foreign investors (with incentive packages) Draexlmaier and Kromberg & Schubert employ additional 6,200 workers and 2,500 workers respectively.[57] In 2015, total exports from the TIDZs amounted to € 1,471 million, a 25 percent increase compared with the previous year, and in Q1 2016, exports from the zones showed a 33 percent increase year-on-year. According to DTIDZ, the segment of FDI in auto component manufacturing has also created spill-overs in transport, logistics, tooling, and auxiliary services (including construction services) that were estimated to be worth € 48 million in 2016.[58]

Looking at the activities of domestic enterprises, as of 2012 there were 38 companies that employed 2,500 people in the automotive industry, only three of which were former state-owned enterprises from the Zastava period.[59] The majority of these local firms also manufacture products for other industries, such as construction, pharmaceuticals and medical equipment.[60] The opportunity to increase specialization and upgrade technology through linkages with the foreign investors in these segments is an opportunity that Macedonia can continue to pursue, and is discussed in section 4.2 below.

3.2 Export Growth and Upgrading

FYR Macedonia's export profile has dramatically changed as a result of the government's FDI attraction strategy and export promotion efforts. The value of merchandise exports increased by 6.8 percent from 2011 to 2016,[61] surpassing pre-crisis levels, which was a fairly remarkable development considering Europe was in the middle of a weak economic recovery and global prices for the country's traditional exports of metals and minerals, which in 2011 comprised 38 percent of the export basket, were declining (dropping by 56 percent over this timeframe).[62] The increase of exports from non-traditional industries, including those driven by FDI, more than covered for this decline.[63] In 2016, exports from TIDZs represented 35 percent of the country's total exports[64] and continued their upward trajectory (see above), while total merchandise exports declined by 10 percent.[65] Exports recovered in 2016, growing at 6.6 percent in that year. The contribution of exports from TIDZs further illustrates both the importance of FDI-driven exports in the country's economy, as well as potential weaknesses in domestic industries.

From 2011 to 2016, the automotive industry, and associated sectors such as chemicals, machinery and electronics, and plastics and rubber, largely drove the increase in exports (see Figure 8). Exports of machinery and electrical equipment more than tripled, from US$314 million in 2011 to US$1.131 billion in 2015. Exports of transport equipment grew by nearly five times, from US$42 million in 2011 to over US$200 million in 2016. Exports related to automotive components may be found across industries—mainly in machinery and electric equipment, but also in textile (upholstery), plastic and rubber (tires), and others. Some of FYR Macedonia's traditional light industries (e.g., textiles and food

57 Quoted in latest discussions with DTIDZ in 2016.

58 Directorate for Technological Industrial Development Zones, 2016.

59 Source: Automotive Cluster of FYR Macedonia (ACM).

60 2012. *FYR Macedonia Sectoral Competitiveness Assessment*. Washington, DC: World Bank.

61 UN Comtrade.

62 UN Comtrade. Prices for iron ore, a major ingredient of FYR Macedonia's metal exports, declined by 65 percent between 2011 and 2016, as shown by World Bank Commodity Price Data (based on annual prices in real 2010 US dollars).

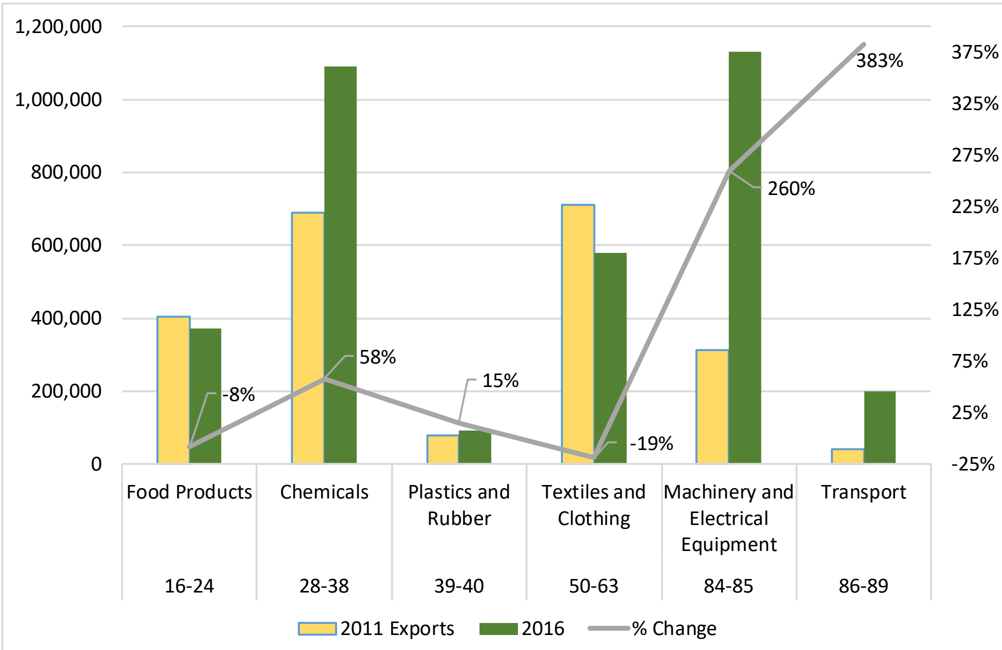
63 World Bank Implementation Completion and Results Report to FYR of Macedonia for the Programmatic Competitiveness Development Policy Operations, 2015.

64 2016 data is from the National Bank of the Republic of Macedonia. According to DTIDZ, exports from TIDZs represented one-third of the country's exports in 2015.

65 UN Comtrade. This data differs from the State Statistical Office's figures, and is used for consistency throughout the report as well as to enable international comparisons that may be done based on this report.

products) remained important components of the country's export basket, but the level of exports contracted from 2011 to 2016.

Figure 8: Growth in Selected Exports, 2011–16 (US$ thousands)



Source: Elaborated by the World Bank Group based on data from UN Comtrade. [66]
Note: All monetary amounts shown in US$.

FYR Macedonia's exports are also showing greater technological sophistication. The share of high and medium tech products[67] in the country's export basket increased from 39 percent in 2011 to 57 percent in 2016.[68] While the country's main comparative advantages remains in the production of intermediate and consumer goods, it has also recently built up revealed comparative advantage (RCA)[69] in new, more capital-intensive products.[70] Figure 9 shows that while the country does not yet exhibit an absolute comparative advantage in machinery and electric products, its RCA in this sector has been growing consistently since 2005. RCA in transportation equipment has also recently shown a large increase. This has contributed to the increase in RCA of manufactured goods overall as shown along the right side of the figure. RCA for more traditional export products (textiles and clothing; food products) has varied, but is exhibiting a declining trend.

66 The numbers below each export category show the HS codes that are included in the category. Transport refers to transport equipment. Data source is UN Comtrade.

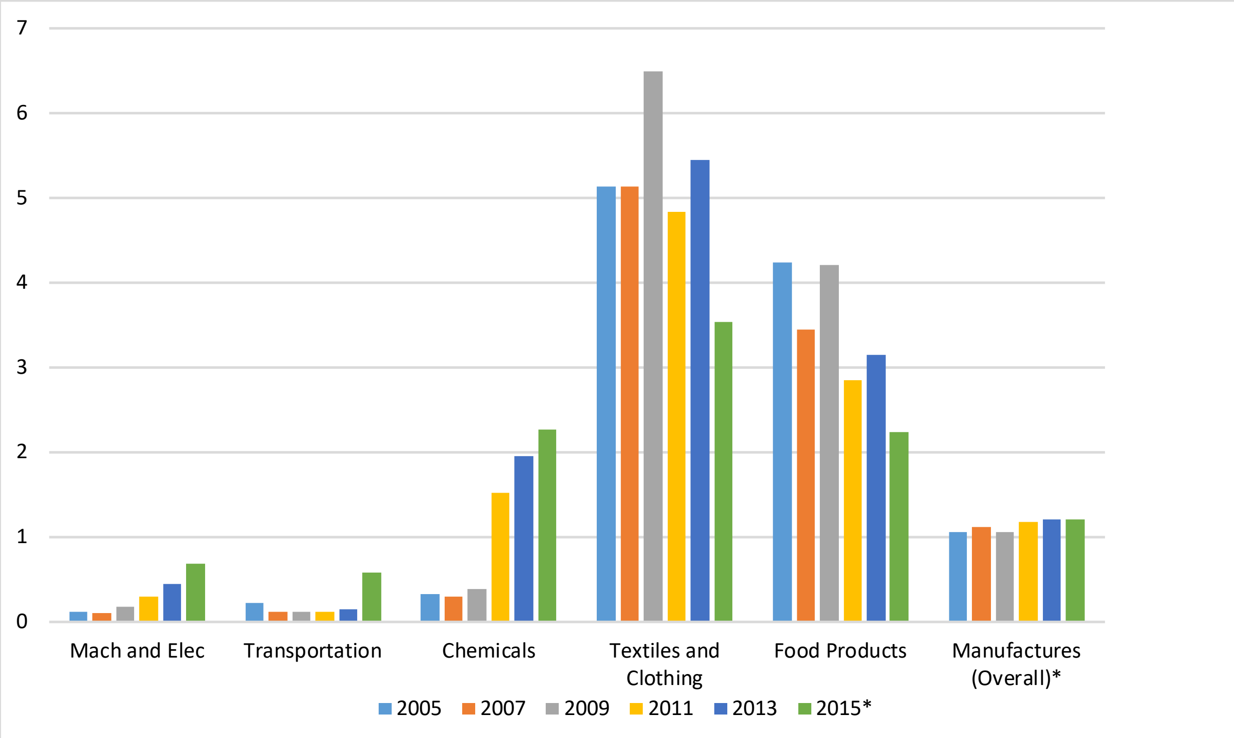
67 Products are classified high, medium or low tech based on R&D intensity. Exports considered to have high R&D intensity are those associated with the aerospace industry, computers, pharmaceuticals, scientific instruments, and electrical machinery, while Medium-tech products are found in industries such as basic and fabricated metals. This report uses the Eustat definition of medium and high-tech exports including those of the following SITC Rev. 3 products: 266, 267, 512, 513, 525, 533, 54, 553, 554, 562, 57, 58, 591, 593, 597, 598, 629, 653, 671, 672, 679, 71, 72, 731, 733, 737, 74, 751, 752, 759, 76, 77, 78, 79, 812, 87, 88 and 891.

68 Elaborated by World Bank staff based on data from UN Comtrade.

69 The RCA index of is measured by the product's share in the country's exports in relation to its share in world trade. A value of less than one implies that the country has a revealed comparative disadvantage in the product. If the value exceeds one, the country is said to have a revealed comparative advantage in the product.

70 IMF. 2015. *The Former Yugoslav Republic of Macedonia Selected Issues*. September.

Figure 9: Revealed Comparative Advantage of Selected FYR Macedonia Exports, 2005–15



Source: Elaborated by the World Bank Group based on data from World Integrated Trade Solution (WITS).
Note: * Indicates 2015 data not yet available. 2014 data used for manufactures.

3.3 Job Creation

The government's FDI promotion efforts have resulted in thousands of new jobs both inside and outside the zones in emerging, export-oriented industries, particularly in automotive components. Between 2011 and 2014, the country's employment rate increased from 38.9 percent to 41.2 percent while the unemployment rate fell from 31.4 percent to 28.0 percent. Manufacturing, agriculture, construction, and the public sector were the main drivers of employment growth from 2009 through 2015. In 2015, employment rose by 1 percent due to new hires in manufacturing, public administration and services (especially accommodation, financial, and real estate).[71] According to DTIDZ, approximately 7,500 new jobs have been created in the zones as of 2016. New export contracts between domestic producers and foreign buyers supported through the government's export promotion measures are likely to create additional jobs, as should the supplier development program aimed at establishing linkages between domestic SMEs and foreign companies.

An analysis of trends from 2010 to 2014 suggests positive changes in the labor market in terms of job creation, related to the expansion of the automotive components sector.[72] Sub-sectors relevant to automotive manufacturing gained approximately 15,500 jobs out of 36,000 jobs across all industries during this period, and employment growth in automotive-related manufacturing sub-sectors outpaced overall manufacturing and industry growth. Job growth in sectors relevant to automotive manufacturing

71 2016. *South East Europe Regular Economic Report: Rebalancing For Stronger Growth*. Washington, DC: World Bank. Spring.

72 Background note forthcoming from the World Bank. 2016 "Estimation of Job Creation and Labor Market Transformations driven by Foreign Investment in Manufacturing in FYR Macedonia."

exceeded 40 percent, compared to 5.5 percent across all industries and 6 percent in manufacturing. Data analysis shows that approximately 90 percent of the automotive-related job growth is attributable directly to expansion of the industry, while approximately 10percent is due to general economic growth. The overall job creation effect is even stronger when indirect and induced effects are considered. Taken together, the automotive sector may have been responsible for the creation of nearly 20,000 jobs over those four years.

The expansion of manufacturing also seems to have created employment opportunities for women and younger people and increased the need for workers in technical jobs. The analysis of these trends is based on manufacturing as a whole, as data was not available at the sub-sector level. It shows the following trends between 2011–14:

- **Gender parity increased in the manufacturing sector and is higher than in the economy as a whole**. Women accounted for 48 percent of the workforce in manufacturing in 2014, compared to 39 percent overall and up from 45 percent in manufacturing in 2010.
- **Manufacturing seems to provide greater employment opportunities for younger workers**.[73] While overall employment of workers between 15–24 years old decreased by nearly 10 percent over the period, the number of jobs held by this cohort in manufacturing has increased by nearly 8 percent. Manufacturing now represents 20 percent of jobs held by young people in this age group.
- **Manufacturing has created jobs for technical workers.** Over the period examined, the occupational groups experiencing the highest employment growths were: professionals, plant and machine operators and assemblers, and service and sales workers. The first two categories represent one-third of new jobs created across all industries in the country. Over 15,000 plant and machine operators and assemblers jobs were created during the period, a number likely driven by the impact of FDI in expanding the production base of automotive components manufacturing.

The impact of manufacturing in generating jobs for younger workers may have several causes. The clustering of young workers in manufacturing sub-sectors might be due to the availability of more and better opportunities, or it may be the result of push factors in sectors other than manufacturing (workers leaving other sectors). An expanding automotive components manufacturing base could also be a driving force behind this trend, since new technology-enabled jobs require computer proficiency and other new-age skills. The policy push from the government to provide incentives for the private sector to provide work-skills oriented training to students may also play a role.[74]

However, the impact on job quality in terms of wages and inclusivity remains in question. In terms of net worker pay, manufacturing has a large share (around 80 percent) of low- to mid-wage earners earning MKD 16,000 per month or less. In aggregate, only about 55 percent of workers across the economy earn less than MKD 16,000 per month. This contrast brings into focus the quality of new jobs being created in the manufacturing sector in terms of their wage level and potential.

While the analysis described above is indicative of employment growth in automotive manufacturing sub-sectors, it is not sufficient for understanding the whole impact of the FDI attraction strategy on the labor market as it pertains to new job creation and job quality improvement. The government of FYR Macedonia should seek to conduct a more detailed analysis to unpack precise trends and measure the impact of the FDI program on the national economy in terms of job creation and skills growth. In doing so, policy-makers will be able to make an assessment of the accrued benefits of a policy involving public funds and land in order to revisit and make any appropriate adjustments to the policy going forward. This is particularly important since increasing technical skills will help to anchor

73 This category is based on international conventions; the minimum working age in Macedonia is 18.

74 The "Law on Vocational Education and Training" that was passed in 2006 and amended in 2008 to address certain gaps in the work-based learning.

industries in the country over the long term. Wages would be expected to increase in line with skills, making it very important that productivity gains offset such wage increases to keep FYR Macedonia competitive.

4 Lessons Learned, Current Challenges, and Future Steps

Overall, FYR Macedonia's strategy, and the methodical way policy reforms were chosen and implemented, has led to positive results. The decision to focus on manufacturing was consistent with aspects of the country's economic history and was grounded in a practical availability of traditional skill sets. The strategy formation process was informed and collaborative. Government officials sought out the experiences of other countries within and beyond the region, internalized good practices, and applied them to a methodology for moving forward. The result was that the full package of FYR Macedonia's offering—tax breaks and other incentives, along with a strong commitment to strategy and a dedication to high-level service—attracted FDI (in automotive in particular), reoriented exports towards more technology-intensive products, and allowed for a strong contribution of exports to growth and employment generation.

However, the program is still underway and the country still faces a substantial challenge to reduce unemployment. It is also becoming clear that the country's ability to continue attracting FDI in the face of market dynamics and increasing competition from neighboring countries is going to present some challenges. The need to upgrade domestic firms has become a pressing priority. The sections below discuss lessons learned, current challenges, and recommended next steps.

4.1 Lessons from Strategy Formulation and Implementation

Based on over 10 years of experience with the implementation of FYR Macedonia's reform and investment promotion strategy, there are clear lessons that can be drawn at this stage. A summary of what was done well, what remains to be done, and possible future actions, is useful for other small economies pursuing an FDI-led strategy.

4.1.1 Success Factors of the Investment Promotion Strategy

In a competitive and globalized market, providing a good business environment along with attractive incentives and an effective marketing campaign **may not be sufficient** to persuade investors to make multi-million dollar investments. FYR Macedonia was able to distinguish itself through commitment demonstrated in investment promotion and the level of service and attention that was given to investors.

Long-term Commitment

Individuals involved in the investment promotion process identified persistence as a key factor in the results of FDI attraction efforts. Investment promotion and attraction is a long process. Results from investment promotion might take years to materialize, but efforts should continue with a long-term perspective. Interviews with relevant officials in the investment promotion process suggest that the cycle from marketing campaign to referral takes on average three years, and half of initial meetings do not generate any follow up for at least five years. Officials in FYR Macedonia have been managing the investment cycle by:

- **Maintaining a consistent year-over-year presence** at major industry (e.g., automotive) events.
- **Using customer relationship management (CRM) software** that allows staff to keep track of companies approached, maintain profiles of important contacts, and keep records of potential investors' plans.
- **Taking time to understand differences** in how potential investors (e.g., United States vs. German firms) make decisions, in order to be better able to influence them. It is important to adapt to the culture of a potential investor and make necessary adjustments with respect

to the timing and method of the approach and the intensity of the engagement for each firm at any one time.

Quality of Service

The quality of service and responsiveness of the overall FDI promotion apparatus to firms has become core to the country's comparative advantage. While the generous incentive package offered was documented as an important reason behind investor interest, the responsiveness and engagement of the country's high-level officials and the learning and increasing professional support from institutions involved in the investment process, were also cited as key selling points. There has been a two-way process, between government and investors, of identifying and resolving issues. Foreign investors have been generally satisfied with the performance of InvestMacedonia and DTIDZ, and credit their proactive role as one of the key reasons for choosing FYR Macedonia. As one potential entrant looking to schedule a visit recently noted: "We got a response to our request letter within 24 hours while other countries took three months." [75] So the quality of service in the TIDZs and other institutions involved in FDI promotion has become core to the country's comparative advantage.

In addition to developing industrial sites and providing tax, customs, and other incentives to attract FDI, DTIDZ provides other services to firms investing in the zones, such as one-stop-shop facilitation at registration and issuance of construction permits. Indeed, international observers and foreign investors have recognized the high standards of TIDZ services. *FDI magazine*, a division of *Financial Times*, ranked the TIDZ in Skopje (along with Russia's Lipetsk Zone) as the best Free Economic Zone for Large Tenants in Europe in 2014. The criteria included the percentage increase in tenants, growth of the zone in the past year, and implementation of new incentives. Foreign investors report satisfaction with the quality of services provided by the TIDZs and attribute their decision to invest in FYR Macedonia to the government's proactive efforts on foreign investment promotion, the quality of infrastructure in the TIDZs, and tax incentives.[76]

The level of government access provided to firms, and particularly to those in the DTIDZ, has become a key part of the value proposition of the country. Priority was placed on addressing the concerns of foreign investors in the zones effectively and efficiently through a formal public-private dialogue process. DTIDZ originally served as an advocate for companies in the zones with its Director providing updates directly to the Prime Minister and bringing to the cabinet's attention issues raised by firms on a monthly basis. Over the last two years, that function has been transferred to the Economic Council, which meets regularly with the government and serves as a platform to systematically address the challenges faced by foreign investors. Several forums are in place to address the concerns of investors as described in section 5.1.2. It is worth noting that this level of access for private firms to national decision-makers is partly due to the small size of the country given the potential impact one investor might have on the overall economy, an advantage that is not typically replicable in large countries.

4.1.2 Challenges to Foreign Investment Attraction Going Forward

The capacity for FYR Macedonia to continue attracting investment in the future with incentive packages will be impacted by several factors: the pressure on government resources, the scrutiny being placed on incentives package, the need to assess demand and enabling factors for new zones, the eventual

75 Interview with a manager at a foreign investor with operations in Macedonia, March 2016.

76 Criscuolo, Alberto. 2015. "FYR Macedonia and the European Periphery Automotive Regional Value Chain, industry-specific global value chain analytics project." Washington, DC: World Bank.

erosion of labor cost advantages, and the lack of supporting industries. Each of these merits further discussion.

Increasing Fiscal Pressure

The World Bank's Public Expenditure Review (PER, 2015) finds that FYR Macedonia's total central government revenues have been on a steady decline, reaching an all-time low of 28.1 percent of GDP in 2013, well below the EU-15 and EU-11 respective averages of 46.0 percent and 38.2 percent, and third lowest among the SEE countries behind Kosovo (27.3 percent) and Albania (24.2 percent).[77] The PER also indicates that the tax incentives provided for FDI attraction, while boosting employment and growth, is a contributing factor to the decline of the revenue-to-GDP ratio. The investors in the TIDZs are entitled to 10 year exemptions from corporate income tax and up to a 100 percent reduction from personal income tax. Furthermore, investors are exempt from payment of VAT and customs duties for goods, raw materials, equipment, and machines.[78]

The country's indebtedness has essentially doubled since 2008, possibly creating risk to macro-fiscal sustainability. Public and public-guaranteed debt, which stood at 23 percent of GDP in 2008, increased to 47.7 percent in 2016 and is being driven by government expansionary fiscal policy. It is currently projected to reach 58 percent of GDP by 2020.[79] While current debt levels are still considered manageable and below the regional average, the country needs to ensure fiscal rigor to ensure sustainable growth going forward.

Increased Need for Monitoring Mechanisms

The European Commission's Progress Report notes an overall lack in the country of effective monitoring and reporting of state aid, lack of an aid register, and no regional aid map, in accordance with EU guidelines on regional state aid.[80] The report also notes that the "Law on Technological and Industrial Development Zones," which governs the incentives packages for companies in the zones, needs to be aligned with the *EU Code of Conduct for Business Taxation*.[81]

Need to Further Analyze Feasibility of Establishing New Zones

There is strong determination to create more zones across the country, but the feasibility and cost-benefit of developing new zones should be further analyzed. The campaign to expand the zones should be informed by assessment of demand and enabling factors. Occupation in the zones is still relatively low: 15 TIDZs are planned in the Directorate's three year program. Only two of those zones currently have an occupancy rate approaching 50 percent, and another three are below 17 percent. Firms tend to concentrate in the zones around Skopje. Skopje Zones 1 and 2 host half of the active firms and 70 percent of the active automotive investments in the zones. Proximity to infrastructure (such as the main airport) and potential employees (from the universities and engineering schools) makes Skopje a more attractive location, particularly for less labor-intensive firms. Public investment in new zones must follow clear market demand. When planning construction of new zones, the government should take into account the pipeline of future investors, the availability of labor with the skills demanded from investors, and the level

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77 General government revenues (including municipalities) stood 30.2 perctage of GDP in 2013, but publicly available time series only spans back to 2009, making it difficult to draw consistent historical comparisons.

78 2015. "FYR Macedonia Public Expenditure Review: Fiscal Policy for Growth." Washington, DC: World Bank. July.

79 2017. According to the "World Bank's Southeastern Europe Regular Economic Report," Washington, DC: World Bank. April.

80 European Commission. 2015. *Progress Report for the Former Yugoslav Republic of Macedonia*. November.

81 The Code of Conduct for business taxation was set out in the conclusions of the Council of Economics and Finance Ministers (ECOFIN) of 1 December 1997. The Code is not a legally binding instrument but requires Member States to refrain from introducing any new harmful tax measures ("standstill") and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code ("rollback"). The code covers tax measures (legislative, regulatory and administrative) which have, or may have, a significant impact on the location of business in the Union. European Commission, Taxation and Customs Union accessed at https://ec.europa.eu/taxation_customs/business/company-tax/harmful-tax-competition_en#state_aid.

of transport connectivity. This will help to focus limited public resources on the zones with the largest potential and lay the foundation for the development of manufacturing clusters.

Participation of the private sector in the development of zones can also help ensure a better market focus. Currently, only one zone (Tetovo) is being developed by a private company. Empirical observations in emerging countries (China in particular) show that private management of industrial zones in a competitive context is beneficial, as zones are incentivized to offer better services. Allowing for greater private management would also free up scarce resources of the government of FYR Macedonia, which is starting to be stretched from managing the growing number of zones.

Investment by Domestic Firms

Although the generous TIDZ incentive package has well served the purpose of jumpstarting automotive FDI flows into the country, it has also come under increased political scrutiny due to perceived disparity in treatment between foreign and domestic companies. The government's policy has been geared towards facilitating FDI in the zones since firms located in the TIDZs enjoy incentives and infrastructure that are not accessible to firms located outside of the zones. The Law on Technological and Industrial Development Zones allows domestic firms to be established in the zones. Such establishment must be new production and not a move of their existing operations into the zones. Some local firms have become attracted to the zones, as exemplified by the recently announced investments of two locally owned, export-oriented companies, Technoplast and Hi-Tech, at the end of 2015.[82]

Thus, there may be several issues regarding attracting domestic firms to establish in the zones:

- The perceived disparate treatment may be in actuality due to the fact that domestic enterprises prefer to scale up operations in their existing premises to benefit from economies of scale.
- Domestic enterprises on the whole may not be generating large, new investment projects.
- Investments by local firms raise questions about lost tax revenue from new operations established in the zones.

Need to Assess the Effectiveness of Incentives

FYR Macedonia would also benefit from a comprehensive and transparent assessment of the impact of FDI incentives on investors' decision-making and a cost-benefit analysis of the package provided to investors. Evidence from global studies of incentives suggests that FDI is most responsive to investment incentives when targeted firms are efficiency-seeking, export-oriented firms looking to increase their global competitiveness.[83] While the firms that have invested in FYR Macedonia certainly fall within that category, a cost-benefit analysis of the incentive package provided by the government of FYR Macedonia has not been conducted. Such an assessment could help provide analytical evidence as to whether the country could generate a similar amount of FDI with a less generous incentive package, and whether investors are likely to leave post-expiry of the incentives. Answers to these questions would be useful to amend and tailor the incentive package and more efficiently allocate government resources, particularly as the country looks to FDI attraction as a means to develop additional sectors of the economy. A framework for evaluating locational incentives can also be applied to other government policies to spur economic transformation, including incentives for innovation and SME development, as discussed below.

Eventual Erosion of Labor Cost Advantage

Low labor costs, one of the country's key advantages in the eyes of investors, are unlikely to provide a sustainable long-term competitive advantage since they tend to erode over time. In looking at the

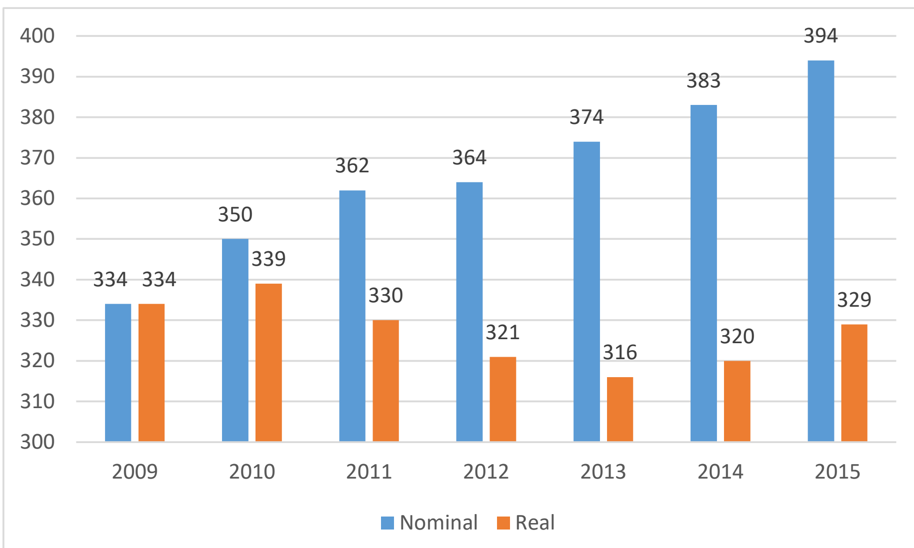
82 Hi-Tech is the first Macedonian company that will invest in a plant in the Skopje 1 free zone. The € 20 million investment is expected to open 300 jobs with 100 people being employed in the first year, according to Hi-Tech's CEO, Savo Stankovic.

83 IMF. 2015. "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment." October.

automotive sector, while foreign investors' location decisions are aligned with the supply chain optimization strategies of the parent companies with regards to the EP RVC, most foreign Tier 1 and Tier 2 companies have selected FYR Macedonia to locate the most labor-intensive phases of production of their respective supply chains. They have been attracted by the relative low cost, availability, and flexibility, of the workforce; the transparency of the public administration (which compensates for slightly higher logistics costs); and the proactive FDI attraction strategy of InvestMacedonia and DTIDZ. Foreign firms located in the SEZs currently represent a 50-50 split between technology-intensive and labor-intensive production in terms of number of companies, and a 75-25 split in terms of investment volumes.[84]

However, cost efficiencies based on low labor costs alone will progressively be eroded as the demand for labor generated by continued influx of FDI on a relatively small workforce increases inflationary pressures on salaries. Nominal labor costs have increased steadily, from EUR 334 in 2009 to EUR 394 in 2015. Real labor costs have fluctuated, but show an increasing trend since 2013 (see Figure 10.) While productivity gains can be expected to offset the rise in labor costs, recent evidence suggests that wages in the country's industry sector cannot fully be explained by changes in labor productivity, and wages may be increasing at a faster pace than productivity gains.[85]

Figure 10: Average Gross Monthly Salary in Manufacturing, 2009–15 (€)



Source: State Statistical Office of FYR Macedonia 2016; World Bank 2016.
Note: All monetary amounts shown in euros.

As labor cost advantages erode, FYR Macedonia's future source of competitiveness needs to be examined. Attracting additional FDI in the tradable sector over the long term would require improvements in fundamentals such as labor skills and infrastructure. Further, the country may want to upgrade its competitiveness in sectors with higher value-added and higher average wages, to support overall improvements in living standards.

Lack of Supporting Industries

84 Criscuolo, Alberto. 2015. FYR Macedonia and the European Periphery Automotive Regional Value Chain, World Bank

85 Trpeski, P., Eftimov, L., & Cvetanoska, M. 2016. "Labor Productivity and Real Wages in Macedonia: An Overview Before and After the Global Economic Crisis." *European Scientific Journal*, (April) 12(10), 352-365.

Foreign investors still face some challenges in and out of the zones due to the lack of supporting industries, although it does not appear that this has significantly deterred investment. For example, some investors noted that there was a lack of real estate developers capable of building or leasing industrial buildings. This meant that foreign investors had to build their own greenfield plants. The government of FYR Macedonia has encouraged brownfield investment to minimize delay to the start of operations and a construction cost subsidy is available to partially alleviate this constraint. However, the country still potentially loses out to competitors where firms are not willing to support the cost to construct and carry building improvements in the zones. Access to local financing for some of the project costs can also be a hurdle as local banks are unwilling to provide project financing or require constraining capital guarantees. Certain firms have turned to other sources of finance such as international financial institutions to get financing. For example, in 2015 the IFC provided an € 8 million loan to United States-based Key Safety Systems (KSS) to build a plant for airbag cushions in FYR Macedonia.

4.1.3 Improving on Past Reforms

FYR Macedonia's strategy to combine improvements in the business-enabling environment with FDI attraction has been successful, but certain elements of the agenda can be improved. Important areas that need attention include those below.

The structure, inclusiveness and quality of public-private dialogue should be improved, especially by developing a structured framework of stakeholder selection, code or manual of public-private dialogue and bringing domestic companies or their organizations into the framework, as well as mechanisms for dialogue with the private sector to improve the communication, transparency, and level the playing field for business in the country. This is especially important as it relates to assessing impacts, quality and gaps of regulations, and proposed amendments to existing legislation and regulations.

Business environment reforms should be deepened and implementation of laws and regulations should be improved. While much progress has been made on improving the business environment as measured by international rankings, there are nuanced aspects of the business environment that are not as well captured in international rankings, which need work. This includes permits, inspections, the degree to which companies have a level playing field upon which to conduct their business. The frequency and timeliness of publication of draft laws and regulations for consultation with the private sector and disseminating information to the private sector on planned or upcoming adjustments in laws and regulations, and ensuring predictability in the implementation of laws and regulations, can also be improved. [86]

More clarity should be provided on the institutional structure for investment attraction. As discussed in section 5.1.2, the activities and mandates of InvestMacedonia, DTIDZ, Ministers for Foreign Investment, Ambassadors, and various economic promoters under the Prime Minister's Office overlap at times and can create confusion for investors. Examining what adjustments could be made that build on the successes and strengths of the program to date and provide more clarity within the institutional structure would be productive.

A comprehensive assessment of the incentives package and cost-benefit analysis of the impacts of FDI, coupled with a clear PPD structure, transparent tools and an inclusive participation from the private sector will be important to guide investment promotion and attraction efforts going forward. This will also help to restore the trust in the institutions and investment potentials, following elections in the country, as the political crisis of 2015–16 has affected FDI inflows and investor confidence.

86 EC 2015 Progress Report for FYR Macedonia point to frequent changes of laws and decline in consultations with the business sector on draft laws and regulations.

4.2 Remaining Challenges and Policy Recommendations for Growth of Domestic Enterprises

Challenges relating to the competitiveness of domestic firms are equally important in the discussion of FYR Macedonia's growth and job creation. The quality of domestic enterprises must be examined and addressed for the country to generate the type of growth it needs to converge to the income levels of the EU and address unemployment. The capacity for technological innovation, degree of product specialization, quality of the products produced, and value of after-sales service are internal considerations that can influence a firm's ability to close a sale, make a profit, or prevent a competitor from taking away market share. Likewise, aspects such as firm-level productivity growth, improving process efficiency, or pursuing a more competitive vision based on a more in-depth understanding of market dynamics are also ways of strengthening competitiveness inside a company. In the case of exports, if companies in FYR Macedonia are failing to meet the same standards as their foreign peers in these categories, then they will not be able to compete as effectively in external markets. This section discusses challenges for firm competitiveness within the country and some ways to address them.

4.2.1 SME Challenges

In FYR Macedonia, SMEs are particularly well represented in the transportation, manufacturing, and wholesale and retail sectors. In wholesale and retail, SMEs accounted for more than 90 percent of all employees and of the sector's value added, which is about one third higher than the EU average for both. SMEs are important in this sector because of the disintegration of medium and large industries and the increasing popularity of one person entrepreneurial businesses following the breakup of the Yugoslav market.[87]

SMEs face challenges penetrating international markets due to internal factors (such as lack of managerial, financial, and technical capacity) and external factors, such as information asymmetries within the newly established, in-country operations of the foreign investors. This was confirmed in assessments made during a pilot supplier development program conducted by the World Bank team. A World Bank assessment of trade competitiveness in 2011–12 also revealed that only 5 percent of domestic manufacturing firms export, but this group of firms generates 55 percent of the total sales revenue in the country.[88] The analysis indicates a strong relationship between exporting and productivity: exporting firms have six times more revenue per employee than the average firm in FYR Macedonia. While part of this can be attributed to self-selection (the most productive firms choose to export), international evidence suggests that participation in export markets does help to improve firm-level productivity. Consequently, a competitive export sector will translate into a more competitive and dynamic economy.

The vast majority of exporters consist of micro, small, and medium enterprises (the median exporter has only six staff), but they represent a small share of total export value. The small domestic market forces many companies in FYR Macedonia to enter the export market early on in their development, when they may not be ready to compete with rivals from the country or from other countries. Not surprisingly, these small exporters have a sizeable productivity gap relative to larger

87 European Commission. 2013. "Small Business Act for Europe (SBA) Fact Sheet: Former Yugoslav Republic of Macedonia."

88 "Making Exports a Catalyst for Economic Growth: An Assessment of FYR Macedonia's Trade Competitiveness," Policy Note 1 of FYR Macedonia Modular Competitiveness Assessment Series.

exporters, which contributes to high export death and exit rates and may hinder the critical process of small firms growing and graduating to become competitive, mid-sized exporters.

The Business Environment and Enterprise Performance (BEEPS) 2013[89] also identifies access to finance among the top three obstacles in the business environment. Closer examination reveals that access to finance and slow credit growth, in particular, are a challenge both on the supply (financial sector) and demand (firm) side. Some of the reasons behind this are risk aversion of the banks and firms (particularly micro and small, which are the majority), high and restrictive collateral requirements, lack of bankable projects, and increasing non-performing loans of firms.

4.2.2 Enhancing the Competitiveness of Local SMEs

Based on a survey conducted in 2015, thriving SMEs in FYR Macedonia identified strong management, collaboration with foreign and domestic companies, innovation, access to international markets, and access to finance as the most important factors behind their success.[90] An identical survey conducted one year earlier also found that successful SMEs[91] put considerable effort into optimizing and expanding their supply chains and supplier capabilities. Managers indicated that in addition to effective handling of issues such as inventories, transport, warehouse location, and product flow, SMEs valued building close partnerships with their suppliers and developing linkages with large companies and foreign investors in the country. Almost all successful SMEs that were surveyed cited foreign and domestic companies as partners, and roughly 65 percent of them were represented in the international market. Successful SMEs also claimed to have improved their products and services at a rate of 1-5 percent a year, achieved one to three innovations per year, invested 1-5 percent of their annual income in research and development (R&D), and invested a similar amount on the development of human resources.

Instruments to help SMEs become more competitive and internationalize are the next step in the country's growth strategy. They include resources to help SMEs develop linkages with foreign firms inside the country and abroad, bolster their skills and innovation capacity, and improve their access to finance. The government of FYR Macedonia currently does not have an SME development strategy, although a draft strategy has been developed at the Ministry of Economy. The government of FYR Macedonia's efforts to promote competitiveness of SMEs would benefit from such a strategy, which should consider the instruments and recommendations in the sections below.

Build Linkages Between Foreign Direct Investors and Local Firms

Despite the progress attracting FDI, local supplier linkages to foreign firms remain largely undeveloped in FYR Macedonia. As of the end of 2016, supplier linkages between companies in FYR Macedonia and foreign investors was estimated at € 48 million in goods and services (including construction), with potential for increase in the medium and long term. In the automotive component sector, while the Tier 1 and Tier 2 investors that have located inside the country are fully integrated in their respective supply chains to serve OEMs in the EP RVC, they have minimal connections with the local Tier 2 and Tier 3 producers as supply chain management, and their procurement strategies are part of their parent groups competitive strategies for the EP RVC.

89 World Bank and European Bank for Reconstruction and Development, 2014. See: http://www.enterprisesurveys.org/

90 Background Note on SME Success Factors for Growth, 2015.

91 Successful SMEs are defined in the report based on (in the last three years): revenue growth, increase in the number of employees, total assets growth, profit growth, and growth of annual investment in new equipment and processes.

Entering into the supply chains of large exporting companies helps SMEs to improve their productivity, quality standards, exporting potential, and (consequently) their competitiveness. One of the critical interventions that facilitates spill-overs from FDI is the presence of backward linkages programs.[92] First, having a program in place that links local firms with foreign investors and multinational corporations (MNCs) and provides greater value addition is important since those connections typically lay the foundation for long-term industrial diversification and export growth. Second, the linkages make a stronger connection to foreign investors. One of the key findings of literature on competitiveness is that developing countries can now industrialize by linking into GVCs instead of building their own value chains from scratch, as Japan or South Korea did in the 20th century.[93] Third, another key spill-over benefit of backward linkages from foreign investors is their potential to help internationalize domestic firms, particularly their suppliers. This is often achieved indirectly by raising demands to meet international standards (e.g., in quality and delivery) and by helping to scale and boost the productivity of domestic suppliers.[94] Fourth, backward linkage projects are also instrumental in attracting additional foreign investors. A thriving base of SMEs that have established credentials supplying regularly to MNCs is viewed as a reason for other MNCs to establish business in the country. Finally, a major benefit of implementing these programs is that it has the potential to contribute to the attraction of further FDI and greater retention of investment in the country.[95] Foreign investors that have developed strong linkages to the host country's economy are less likely to leave due to the expense of building new supplier networks. For these reasons, FDI promotion and backward linkages projects are both complementary to the overall agenda of the government.[96]

A number of successful supplier development and backwards linkages programs have been implemented over the past two decades in Europe, Central Asia (Czech Republic, Kazakhstan, Russia, Serbia) and Latin America (Coast Rica, Chile) that offer some lessons and guidance on how to shape and execute strategy. SME support programs with supplier development and backward linkage aspects have also been undertaken around the world and offer special insights to policy makers. Successful linkage programs usually have several characteristics in common: close and active involvement of investors, enthusiastic commitment and ambition of participating suppliers, and input and support from specialists in a coordinated and customized package.

Considering the lack of integration that now exists between domestic and foreign firms, building linkages between the two is becoming a priority for the government of FYR Macedonia. In 2014, the government established an inter-ministerial working group on the automotive industry chaired by the Ministry of Finance to devise a coherent strategy for the industry and focus policy efforts on the establishment of backward linkages with the domestic industry. DTIDZ, InvestMacedonia, the Foreign Investors Council, and other institutions[97] were part of the working group. The lack of a specific implementing entity was complemented by the active engagement of the World Bank through a pilot supplier development project (conducted in February–December 2015), which focused on the collection and dissemination of supplier information, capacity building and training, and the upgrading of suppliers and extensions of technology.

92 Farole and Winkler. 2014. "Making Foreign Direct Investment Work for Sub-Saharan Africa." Washington, DC: World Bank.

93 Reis, Jose. "Global value chains and Competitiveness Assessments: Some Lessons Learned." Washington, DC: World Bank.

94 Gupta, Ravi. 2015. "FYR Macedonia: Supplier Development Program Analytical Note, Ascending the Global Value Chain by Developing Linkages among Small and Medium-Sized Enterprises (SMEs) and Multinational Corporations (MNCs)." Washington, DC: World Bank.

95 UNCTAD 2001; Czech Suppliers of Multinational Corporations: Benefits and Challenges.

96 Crescenzi et al. "Innovation Drivers, Value Chains and the Geography of Multinational Firms in European Regions."

97 Other entities included: Cabinet of the Deputy Prime Minister for Economic Affairs, Ministry of Economy, Ministry of Labor and Social Policy, Macedonian Bank for Development and Promotion, and the Fund for Innovation and Technological Development.

The pilot Supplier Development Program (SDP) aimed to build the capacity of domestic firms and strengthen their linkages with foreign investors. The findings from working with domestic suppliers through the pilot SDP include:

- **There is a lack of publicly available information** about foreign investors and their supplier needs.
- **Approaching investors can be a difficult process for domestic enterprises**, especially reaching procurement managers. In cases when there was already a contract and established relations between a local firm and a foreign investor, the investor often approached the local supplier.
- **When local SMEs are able to obtain a contract with a foreign investor, it is likely to be *ad hoc*** and rarely leads to a long-term engagement.
- **If the inputs supplied by a local SME are to be included in the production process**, the process of negotiations, including quality testing, usually takes more than a year.
- **Local companies have achieved growth on traditional markets,** but to scale up sales to the global market requires significant effort and a long-term vision with concrete improvement actions over a five-year horizon.
- **Companies' management typically know the local market well,** but many of them need to invest more time to improve their understanding of their global market and the requirements of foreign investors. This will help them develop strategies to compete with low cost suppliers in emerging economies.
- **There is no scarcity of investment in machinery and equipment;** however, there is sub-utilization of resources and a need to optimize production according to the principles of lean manufacturing and continuous improvement.
- **Further investment in training for managerial skills,** as well as for technical, quality, and sales personnel, are essential for long-term development and contracts with foreign investors.

Through the pilot SDP, specific areas of technical assistance were identified for local firms wishing to become suppliers to foreign investors. Listed in order of priority, they were: developing marketing and promotion strategy; facilitating communications with foreign investors; implementation of technical standards and lean manufacturing and supply chain management best practices; implementation of corporate governance best practices (such as succession planning or improving internal control processes); optimization of production processes; and developing feasibility studies for new investments.

There may also be benefits from continued FDI attraction efforts in other export-oriented industries in which FYR Macedonia has an existing supplier base on which to build linkages and generate spill-overs. Targeting investment promotion efforts on strategic investors that are suppliers or buyers of existing domestic industries would greatly increase the economic multiplier impact of the FDI, as there will already be a competent supply base to service the needs of the foreign investors, with limited support required from the government or the investor. Opportunities for this in sectors such as agribusiness, apparel, ICT, and tourism should be explored further.

Promote Exports of Domestic Products

There is potential for InvestMacedonia to expand its export promotion efforts into areas that provide more market intelligence, and build capacity in firms that are exporting or have potential to export. Following the adoption of a strategy for export promotion and establishment of an export promotion unit in InvestMacedonia in 2010, a first generation of exporter support programs was developed and introduced in 2012–13, with support from USAID and the World Bank-financed

Competitiveness DPL. In 2014, the funding for InvestMacedonia was increased by 35.5 percent over the 2013 budget to a total of € 9.2 million. This enabled the organization of business-to-business (B2B) events and co-sponsoring participation of companies in FYR Macedonia at international trade fairs. At least 120 Macedonian companies took part in export promotion events, and about 50 firms signed new export contracts. There is an opportunity for InvestMacedonia to further develop and expand its offerings overall and for key exporting sectors. The first step may be to update the country's export promotion strategy, which has expired.

Invest in Skills, Innovation, and Technology Transfer

To further increase SME competitiveness in FYR Macedonia, the systems and ecosystem for enterprise upgrading and innovation should be strengthened. Given the country's level of development, challenges, and global competition, development of skills, innovation, and technology transfer are particularly relevant. An assessment of the performance of private sector firms in 2008 and 2011 revealed significant gaps in the national innovation system.[98] The growth and profitability of firms, especially SMEs, are hampered by a lack of skills, limited investment in new technologies, and difficulties in fostering partnerships with demanding foreign investors. Most enterprises operate at low levels of technological sophistication, have a limited knowledge base, and are positioned low within the value chain. While there are identifiable sources of knowledge in Macedonia's universities, research and development (R&D) institutes, and within business development providers, the linkages with potential users of knowledge were limited. The *2013 Enterprise Survey*[99] reveals that collaboration with external research organizations was reported by only 0.5 percent of innovators in Macedonia. Firms must rely on continuous product and process innovation to improve their positions in new and existing markets.[100] Challenges in the country's R&D and innovation system could further widen the technology gap with current and potential EU members, and could, in turn, affect the country's ability to compete in an integrated EU market.

To improve the innovative capacity of businesses, the government of FYR Macedonia adopted a systemic approach to promoting research, development, and innovation, drawing lessons from similar experiences in other countries in the region (Croatia, Serbia, Bulgaria) and beyond (Finland, Israel). The first steps were toward strengthening the strategic, regulatory, and institutional framework for innovation with support from the OECD and the World Bank by adopting the *Strategy for Innovation* in October 2012 and the "Law on Innovation Activity" in May 2013. The World Bank provided support to the policy reforms through the *Programmatic Competitiveness Development Policy Loan* series and the *Skills Development and Innovation Support Project*. The "Law on Innovation Activity" designated the Fund for Innovation and Technological Development (FITD) as the entity to channel the government's stimulus to innovation in the private sector. FITD was established in 2014 and introduced financial instruments to support new start-ups and spin-offs and the commercialization of technology and technology transfer activities that connect research to the market. The Fund also acted as a source of innovation funding and upgrading for FYR Macedonia's national innovation system. Additionally, a "Memorandum for Cooperation" between the largest research and educational university, Ss. Cyril and Methodius in Skopje, and the Macedonian Chamber of Commerce, may be leveraged to strengthen cooperation on R&D projects.

FITD has developed four instruments for innovation financing. These instruments have been developed and funded initially from government sources, and have also benefitted from technical assistance and available funding (US$12.9 million) from the World Bank. From its establishment in 2013, FITD has supported 37 start-ups and spin-off companies through those instruments and dedicated itself to

98 2008

99 Conducted by the World Bank Group and EBRD. See: www.enterprisesurveys.org

100 In this document "innovation" refers to the successful production, assimilation and exploitation of novelty in the economic and social spheres (EU definition).

promoting and raising awareness for innovation in Macedonia. In the last two years, the fund has organized numerous events, conferences, and trainings regarding its main activities. The fund currently has six employees, some of whom have participated in knowledge exchanges abroad and participated in numerous innovation-related trainings.

FITD's instruments are: (i) co-financing grants for start-ups and spin-offs, (ii) co-financing grants and conditional loans for innovation commercialization, and (iii) co-financing grants for technology extension services. An instrument to provide funding for business-technology accelerators is under development. The instruments are being launched in stages, drawing on lessons from previous rounds of funding and improving on the design of the instruments. Three calls have been carried out to date, focusing on the first two instruments (start-ups and spin-offs, and innovation commercialization).

In addition to the existing instruments, there is room to further facilitate innovation and technology adoption by improving access to information and expanding the approach to technology extension services. Specifically:

Enable more direct access to cutting-edge information and best practices on the latest innovation, technology, research, and support for commercialization in various industries.

Develop technology extension services, defined as the "deployment of outreach mechanisms in the field to stimulate companies to acquire or improve their use of technology and stimulate innovation" to improve firm productivity, quality, product performance, workforce skills, and learning capabilities.[101] FITD is currently developing this instrument and lessons should be learned from its implementation. Particularly, the question of how to institutionalize firm-level diagnostics in the approach should be further explored. Firm-level diagnostics may be useful for other FITD instruments as well.

One way to operationalize and scale up innovation and technology extension services is through industry-specific centers. These centers would aggregate information on the latest developments in the field through collaboration with international and local partners in research, technology, and industry. They could also develop and deliver outreach and services to firms to assist with technology adoption and elevation of productivity at the firm level. The types of services offered could include information provision, benchmarking and assessment, technical assistance or consultancy, training, group or network services, collaborative projects (e.g., R&D, implementation), strategy development, and coaching and mentoring. Consideration should be given to existing institutions and evaluations made as to the extent to which they can be leveraged for enhanced partnerships and implementation capacity. If the government of FYR Macedonia wishes to support such efforts, the next step would be to conduct a feasibility study and undertake a detailed design of the initiatives and delivery mechanisms.

Labor force skills also require upgrading in order to position firms in the country to increase their productivity and competitiveness. This will benefit domestic firms as well as investment attraction efforts. One barrier cited by investors is a lack of qualified labor for their operations. Technical skills (e.g., to operate machinery and perform production functions) as well as soft skills (e.g., punctuality, team work) require improvement, according to interviews with foreign investors and domestic enterprises. Ways to improve skills include: (i) better aligning curricula, including in technical and vocational education, to labor market needs; (ii) including training on soft skills in relevant curricula; (iii) further promoting linkages between educational institutions and enterprises (e.g., through internships that fully immerse students in relevant production processes); (iv) promoting the development of lifelong learning, including through educational service providers that offer technical training for individuals who are have

101 Shapira et al. 2011. "Building Capabilities for Innovation in SMEs: A Cross-Country Comparison of Technology Extension Policies and Programs," *International Journal of Innovation and Regional Development.* 3-4: 254-272.

finalized their formal education and are currently employed (this requires a shift in the approach from the pedagogical approach of adult learning to a focus on developing skills that are required in the labor market); and (v) promoting the provision of on-the-job training within firms.

Increase Cross-Border Collaboration

The country would benefit from greater trade collaboration with its neighbors in the Western Balkans to generate economies of scale and raise the level of its competitiveness relative to other larger and more advanced economies in the region, such as those of Turkey, Poland, and the Czech Republic. For example, the report on the automotive value chain in FYR Macedonia points out that the EP RVC is constituted by a well-integrated production network, meaning that "value chain entry and upgrading opportunities for suppliers in FYR Macedonia are not limited to the procurement needs of Tier 1 or Tier 2 FDI located in Macedonia, but to the whole network of OEMs, Tier 1, and Tier 2 FDI present in the European RVC."[102] The report goes on to say, "The design of any supplier development program should be informed by a mapping of such insertion opportunities throughout the European RVC, and not just focused on Macedonia, as past programs have done." Economies of scale can also be created by improving cross-border trade regimes, such as taxation and logistics, and access to pools of qualified human resources. Initiatives supported by the World Bank Group on regional trade facilitation and light manufacturing may also provide platforms for expanded regional collaboration.

102 Criscuolo, Alberto. 2015. "FYR Macedonia and the European Periphery Automotive Regional Value Chain, industry-specific global value chain analytics project." Washington, DC: World Bank.

5 Conclusion

The strategy and program launched in FYR Macedonia to upgrade and transform the manufacturing sector remains a remarkable success story. Now after 10 years of an overall successful approach, it is time for government and business leaders in the country to take stock and look at sustainability in light of emerging challenges and unaddressed issues. Recommendations outlined in this report include the need for a cost-benefit analysis of incentives, particularly in light of further expansion of the DTIZs and emerging macroeconomic and fiscal pressures, and greater coordination among the investment promotion agencies to reduce redundancies and conflicting agendas. The government of FYR Macedonia should evaluate the quality and sustainability of jobs being created under the program and prepare for the eventual erosion of labor cost advantages. Political controversies that threaten the positive brand image that the country has built in the investor community also have to be addressed. Finally, serious thought must be given to how to continue creating an attractive business environment, beyond progress on the *Doing Business* indicators, and how the government can further facilitate increased productivity and competitiveness at the firm level, including through increased innovation and technology adoption.

Some encouraging steps in this direction are already underway. The emerging focus on the innovative capacity of businesses through FITD, and interest expressed by the government of FYR Macedonia to expand the Supplier Development Program, for example, should go a long way to create conditions in which those spill-overs can take place.

However, at this juncture it is important for all parties to recognize that in certain respects the country is reaching a new phase in its development trajectory. With large pieces of the original agenda in place, the program is now entering a stage in which—in order to reach the country's ultimate goals—the government faces the need to pivot to address more fundamental and complex issues relating to the competitiveness of the local private sector, an area that represents a more significant challenge to the government in a number of ways.

First, the government, while still a critical player, will have less control over the implementation of the measures that will drive success. Up until recently, strategy and policy formulation and implementation by the government of FYR Macedonia has been a structured and deliberate process. Implementation of reforms and programs was performed in a familiar top-down, centralized, fashion, and benchmarks were fairly easy to define and achieve through direct government action (i.e., either reforms were made, and development zones were built or they were not). Now needs are emerging in areas in which goals are harder to define and the perception of progress can be more elusive. Expanding program objectives into areas such as the creation of backward linkages, skills training, and innovation support is, in many ways, a tacit acknowledgement that the country is entering the black box stage of development. In this phase, measures are less prescriptive, and policymaking becomes less *mission-oriented* and more *diffusion-oriented*, adding layers of complexity and uncertainty to the agenda. Instead of comfortably exercising levers of power to improve a regulation, build an e-portal, or construct a road, the government of FYR Macedonia will have to understand and respond to a cascade of events taking place outside the government, involving many more actors with many more needs, wading into issues ranging from venture capital financing, to market intelligence, to whether or not the education system provides the right skill sets. These are new responsibilities for the institutions involved and will require a new mindset, approach, and an upgrade in the skills of the people and institutions managing the development agenda.

Second, the timeframes for reaching new objectives in this phase of growth will be longer. Investments made in improving market knowledge, or training in technology, or increasing the ability of companies to innovate, can take time to produce concrete results, even in the rare circumstances when new objectives can quickly be defined and acted upon. This seems obvious to the casual observer, but in reality, considering the pressure the country is under for rapid change, there has to be clear recognition (and an appropriate government, private sector, and societal mindset) that progress in this phase will only be realized in gradual, incremental steps.

Third, it is also important to be reminded that as new objectives are defined or expanded in this new phase, the dynamics on the ground will be changing. Government and business leaders will be encountering shifts in demand associated with increased competition, particularly from Asian producers seeking to gain closer access to EU markets. Business leaders will be facing shifting markets and competing technologies. Companies competing in the automotive sector will have to show that they can adapt to new product lines, and the processes they are using now will have to become more efficient if they hope to maintain their competitive position. Whatever they are doing today to attract business will not be sufficient to keep it, and this need for more constant innovation is something that has to shape future interventions.

In considering these new challenges, the authors of this report believe that the need for an improved public-private dialogue, as described and recommended in this report, becomes particularly important. The fact is that on top of the fundamental strategic decisions all businesses have to make, companies in FYR Macedonia increasingly need to look for opportunities outside their borders, make investments in process improvements or skills development, raise the level of product quality and customer service, and undertake a host of other activities that add elements of risk and uncertainty. How prepared they are to seize these opportunities and take on these risks, measured against the potential reward, will determine their level of competitiveness and whether sustainable growth can occur naturally. Progress will ultimately hinge on FYR Macedonia's leaders and workers to collectively absorb information and find new resources and behave more interactively with the outside world and with each other to generate new networks and relationships.

Much of the country's future success will depend on the private sector's ability to leverage its developing expertise in automotive manufacturing into other industries, acquire new competencies and skills, seize opportunities for diversification, and foster innovation so it can develop competitive advantages and better adapt to changes in markets and technologies. Importantly, **political and business leaders will have to continue to exhibit the kind of leadership and dedication that they have shown thus far to put vision into action.** All of these things can be advanced more rapidly and effectively if information flows well between the government and the private sector on important matters. How the participants use what they learn in that dialogue, to refine strategies and direct resources in a manner that encourages processes taking place in the private sector to go forward, may determine whether enterprises, and the country as whole, will be able to take the economy to the next level of competitiveness.

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