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Skopje, May 2012

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**Original scientific paper**

**Tatjana PETKOVSKA MIRCEVSKA\*)**  
**Diana BOSKOVSKA\*\*)**

## **MARKETING COMMUNICATION AND THE “CULTURE OF SERVICES” IN ALTERNATIVE TOURISM**

### **Abstract**

One of the most important characteristics of the holistic marketing concept is based on idea that in creating the quality and value of market offerings, especially the services, customers as well the „service providers” are equal part of the whole marketing process. The „culture of service” in the alternative tourism means effectively marketed and successfully delivered services in order to satisfy customer’s needs. Services should be delivered to the smaller and specific market segments, even individuals, by creating an optimal form of marketing communication in the external and internal environment.

The specific characteristics of alternative tourism services require an efficient marketing communication to become a business and marketing philosophy for all stakeholders in the value chain. In the process of creating superior value, it is very important to create the „culture of services”, as well as to develop efficient human resources and exchange relevant internal and external marketing information’s in the process of marketing communication. The external marketing communication focused to different market segments (groups or individuals) is created as integrated system of the different communication tools. The internal marketing communication is used among the participants in the value creating process in alternative tourism services, in order to provide efficient information exchange in the internal communication system. At the end, an optimal combination between external and internal marketing communication becomes essential in creating „culture of services” as the most important part in the process of creating the superior customer value and distribution of alternative touristic services to the target market segments.

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## **Introduction**

The integration of forms and approaches in implementing the communication to internal and external public in alternative tourism is in fact, process of communication on several levels: within the subjects in the alternative tourism sector (local stakeholders and service providers, travel agents, dealers, national and local tourist agencies, rent-a-car companies, aviation companies, government institutions) and between stakeholders and end users (customers).

The meaning of internal and external marketing communications is an integral part of the process of creating the "culture of service" in its broader sense. The alternative tourism product/service marketing is a very complex process. It occupied specific market segment, characterized by specific needs and requirements. In the sense of creating long term relations with the clients, creating the culture of services become more than developing a new product or price determination. Probably the most important is how to create the integrated marketing communication as important part in building long term relationship and loyalty with the target market.

The paper is focused on the specificity of alternative tourism services and the importance in building "culture of service" as a base for effective communication on different levels, in order to make this service more competitive in the sense of creating long term relationship with the customers.

## **1. THE MEANING OF ALTERNATIVE TOURISM**

At the end of the 20<sup>th</sup> and the beginning of the 21<sup>st</sup> Century, the touristic market expansion arises many changes in the scope and nature of touristic demand on the global level. The interest for alternative tourism in relation to massive tourism increases the interest for its theoretical research and practical implementation.

The meaning of alternative tourism is based on products and individual tourist services, different from mass tourism by means of supply, organization and the human resource involved. The alternative tourism has a wide variety of

meanings and was put forward as a response to the excesses associated with mass tourism.<sup>1</sup>

In general, there are two main types of tourism: (1) mass tourism, and (2) alternative tourism.<sup>2</sup>

Mass tourism is characterized with a weak interaction with local communities and big touristic resorts, while the alternative tourism is based on small or medium companies created by individuals or groups connected with family or friendly ties. Alternative tourism is also characterized with large possibility of contacts with the communities and the environment

The diverse tourism types are created from the experiences that tourists gain according to their specific needs they want to experience. Each type of tourism is a way to give a denomination to a new market niche for a different experience. The types and forms of alternative tourism could be cultural, ecological, traditional, food and beverages etc. One approach in many different classifications of alternative tourism services can be classified as follows<sup>3</sup>:

- The "Natural", which includes: adventure tourism, ecotourism, and nature tourism
- The "Cultural" includes the archaeological, rural tourism, religious and ethnic.
- The "Events" includes sports, carnivals and festivals
- Other types: volunteering, farm stays, educational tourism, etc.

## **2. THE MEANING OF „CULTURE OF SERVICES“ IN ALTERNATIVE TOURISM**

In marketing theory, the concept „culture of services“ is defined as one aspect of building strong internal marketing concept, as well as a aspect of building the organisational culture of the company.<sup>4</sup> It means training activities among employees for giving higher value to the final consumers. In alternative tourism, building strong internal relations as a concept should be used as an approach in building the system of culture of services among all stakeholders on macro and micro level.

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<sup>1</sup> [wps.pearsoned.co.uk/wps/media/objects/1881/1926829/glossary/glossary.html](http://wps.pearsoned.co.uk/wps/media/objects/1881/1926829/glossary/glossary.html)

<sup>2</sup> <http://www.ecoturismolatino.com/eng/ecotravellers/alternative/articles/altertourism.ht>

<sup>3</sup> <http://www.ecoturismolatino.com/eng/ecotravellers/alternative/articles/altertourism.htm>

<sup>4</sup> Kotler, Boven J. et al: Marketing in hotel industry and tourism, (translation), Skopje, 2010, p. 282.

The alternative tourism as a profitable but at the same time, activity with larger social significance and national interest, is on high importance for the image building and increasement of tourism export. In alternative tourism, the stakeholders in the value chain have to be connected, which is important for delivering the final service and reaching the consumer loyalty on a long term. The services in alternative tourism are specific and oriented on specific, mainly smaller customer groups. So, the significance of the „culture of services“ is multiplied, and it becomes not only one aspect of internal marketing, but also its final goal. Other aspects like marketing approach in human resource management and spreading market information among stakeholders in the value chain, becomes a part of the activities for reaching higher form or model of the „culture of services“ for an appropriate service in alternative tourism.

For an appropriate business in alternative tourism, it is important to analyse how the internal and external system of marketing should be created and integrated. First of all, the communication activities have to be planed, starting from the determined goals: cultural-educative, recreative and unlike, achieved by developing the interes to all stakeholders network. The partial goals are oriented on more specific targets, as for example to reach more customers in specific period with differentiated offerings (farm tourism-breakfast in nature, food tourism-degustation of rare types of wines etc). In both cases, different tools of marketing communications should be used, and in the sense of communications, the common goal is accomplished: increasing the interes, awareness, and persuasion for the specific alternative touristic service as a result of the integrated communication and position of the differentiated touristic offerings on the market.

### **3. SOME CHARATERISTIC OF INTERNAL AND EXTERNAL COMMUNICATION IN THE ALTERNATIVE TOURISM SERVICES**

In general, the corporate communication is defined as the management functions of a company responsible for communication processes that are initiated by the organization and different groups of interest from the internal and external environment. The authors Herle and Rustem in selection and structuring of the target public groups use two criteria<sup>5</sup>: the power of impact of the target group of public (stakeholder) and the level of interest of the corporation in respect of a specific target group (Table 1).

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<sup>5</sup> Herle, Rustem, Corporate communication worldwide: an introduction, Wolters-Noordhoff, 2005, p.17.

Corporate communication sector, in addition to the structuring of stakeholders performs other functions (activities) also, such as:

1. Monitoring activities of the stakeholders through print media, websites, TV and radio programs and more.
2. Individual communication with stakeholders.
3. Meeting with stakeholders on the meetings and conventions.
4. Maintaining relations with the press and otherwise.

**Table 1. Factors for selection of stakeholders**

		Level of interest	
		Low	Heigh
Power	Low	Minimum effort for communication	To be inform
	Heigh	Sustain the satisfaction level of communication	Groups of strategic interest

Source: Herle M., Rustem C.: Corporate communication worldwide: an introduction, Wolters-Noordhoff, 2005, p.27.

It was already mentioned that from marketing aspect, communications are treated in internal and external context. The development of information needs and the implementation of new technology and Internet become a base for newest approach in marketing communication and a base for the new contemporary "holistic" marketing concept. In alternative tourism, the role of holistic marketing concept is more significant because of the characteristics related to the nature of touristic services.

The marketing communication is defined mainly as a system or "elements of the whole, related and connected with the same function<sup>6</sup>. The communication flow means movement of information to the specific target audience in one direction, and a feedback mechanism of information as a part of the whole communication system. In the developed market economies, this

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<sup>6</sup> Kostic B.: "Market communication, theory and practice", Beograd, 1988, p. 41

approach implemented in the promotion strategy is known as integrated communication process. In general, there is an increasing significance of tourism services on the global market and the world economy in present conditions. The new forms of alternative tourism services significantly changes the ways and forms of the touristic offerings according some contemporary conditions and customer habits in the modern societies. Also, there are a lot of changes in marketing communications as part of the corporative internal and external communication with the different target market groups.

The internal and external communication in alternative tourism are essential in creating the image and reputation as the base for distribution of superior value and differentiated services on the market. For different types of alternative tourism, the importance of internal communication increases, so the efforts are given to the stakeholders, especially service providers, to react in direction of increasing the interest and satisfaction of the target market.

For the final users, external communication efforts are oriented in creation the image and reputation of services and to accomplishing the social responsibility in broader sense. Given the diversity of stakeholders to use an appropriate communication channels in information exchange to the target groups that appear as most critical for building the image, allows uniform approach towards environment, that is necessary "to speak one language" to the various target groups of the public.<sup>7</sup>

The new contemporary integrated system of communication is created in optimal combination between marketing communication tools and elements and is the core part of an integrated marketing strategy for the specific touristic services. The communication mix is created as optimal combination of different promotion tools: the advertising, promotion, public relations, publicity, personal selling and the direct marketing in the system of integrated marketing communication. Each of them is determined by specific characteristics which have to be defined through the process of creation and implementation into an integrated and comprehensive communication process.

The internal communication is a permanent process of establishing good relationship in the company, employees, management, customers and other stakeholders. Some forms of internal communication includes publicity, different events, sales promotion etc. External communications are oriented to the customers and other publics, by using traditional or on-line communication. In alternative tourism, this type of communication could be personalized and oriented to smaller markets (groups, individuals...) in the base of "customerisation" or "one-to-one marketing".

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<sup>7</sup> Harvard Business Scholl Press, Essential of corporate communication and public relation, Harvard Business Press, Boston, 2006, p.6.

The separate tools in marketing communication are a parts of an appropriate communication mix. For example, in culture tourism, most often, direct marketing or advertising campaigns are used as a form of external marketing communication. The combination of marketing communication tools and elements is specific from the stakeholder aspect and the implementation of the promotional push or pull strategy.<sup>8</sup>

In Republic of Macedonia, different stakeholders in alternative tourism are involved in the integrated communication process. On the institutional level, there are few institution representatives for tourism promotion.([www.exploringmacedonia.com](http://www.exploringmacedonia.com) and other web sites) **The Agency for Tourism Support and Promotion** on national level developed in 2008 year, promotes tourism resources and capacities on the international level. Also, in order to attract tourists in Macedonia as a unique touristic destination, the multiple stage campaign **Macedonia – Timeless**, sponsored by the Macedonian Government, was initiated in 2008 videos already being broadcasted on worldly renowned media such as CNN, and a web-portal: [www.macedonia-timeless.com](http://www.macedonia-timeless.com). The web portal [www.exploringmacedonia.com](http://www.exploringmacedonia.com) is also a part of the internet promotion of tourist capacities and beauties of Macedonia, as well as the tourist offer for various types of tourism. Many municipalities have already prepared Development Strategies, a specific part of which is **Alternative Tourism Development** ([www.exploringmacedonia.com](http://www.exploringmacedonia.com) and other web sites) There are a lot of interesting destinations for alternative tourism as Kavadarci (wine tourism), Berovo and Pelister (ecotourism), Mavrovi Anovi (natural tourism) etc. The World Magazine Forbs has chosen Macedonia among 20 most interested destinations in traveling in Europe, in the relation Prespa-Ohrid, through Galicica. The external communication with the target audience is organized mainly by advertising campaigns, and in that sense Internet is one of the main media (example: [www.GoMacedonia.com.mk](http://www.GoMacedonia.com.mk)). It is expected that in the near future, in order to create an efficient “culture of service” for alternative tourism, more subjects in internal and external communication should be involved, and more communication tools will be used in building an integrated efficient marketing communication strategy. It is an optimal approach for reaching the final goal- Macedonia to be recognized as interesting and well organized destination for alternative tourism in a global market. , its first

## CONCLUSION

The characteristics of alternative touristic services requires a specific marketing approach and in that sense, specific marketing communication activities. In general, in the begining of the 21th Century, the information and

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<sup>8</sup> Kotler, Boven J. et all, 2010, p. 392.

digital era determines all business to exist and survive on the market in extremely turbulent and changing conditions. For different business, the implementation of technical and technological innovations has strong impact on the development of internal and external marketing communications, which is also implemented in the alternative tourism sector.

In present, internal communications becomes very significant in growing and developing the business. The alternative turistic services are extremely significant because of their nature and the importance of communication in creating the „culture of services“. The internal communications means effective communication among different stakeholders in the value chain, including government institutions, tourism organization and small and medium companies created by families or friends, where there is the possibility of more contact with the communities and where most of the times there is a respect for the environment.

The integrated communication is based on many activities: analyzing, planning, implementation and controlling the internal and external communication. In present conditions, there is a severe competition in the tourism sector on the global market and the customer needs are changing in more dynamic way. The implementation of new "holistic "or cyber marketing concept is a base for implementation of the new, more sophisticated form and combinations of marketing communication tools. As important part of the process of the building the „culture of services“, the integrated communications become a base for differentiation and strong market image of the alternative touristic services in extremely changing conditions on the global market.

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**Original scientific paper**

**Neda PETROSKA-ANGELOVSKA \*)**  
**Marija ACKOVSKA \*\*)**

## **INVESTMENT IN MACEDONIAN ECONOMY IN TERMS OF ECONOMIC CRISIS**

### **Abstract**

This article elaborates issues related to the achieved level of investment activity in the Republic of Macedonia, having in mind the global economic crisis.

For that purpose investment in fixed assets during the period of 2005-2010 are analysed. The investment activity is mostly observed by total scope of investment, their share in GDP versus share of depreciation, and in that manner rate of investment is estimated. The objective of further analyse is structure of gross fixed capital formation by purpose of investment and by type of ownership, also. This approach provide data of investment allocation by sectors of economy and their engagement in more or less propulsive sectors of economy and indicate types of ownership and their participation in formation of gross fixed capital. The analyze in this article is mostly based on statistical method, using official statistic data.

The results of research in this paper show reduced investment activity, mostly as a result of global economic crisis. The structure of investment is not favourable and almost is the same before and after 2008. Namely, dominant share of investment are allocated in construction sector, mostly directed to building of housing projects and only small share refers to building or improvement of industrial capacities.

More dynamic growth of investment activities and more favorable structure of investment prerequisites concrete measures and activities toward improvement of investment clima and stimulation of domestic and foreign investors.

**Key words:** investment, depreciation, gross fixed capital formation, economic crisis Republic of Macedonia.

**JEL Classification:** E22

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## **Introduction**

Investments are considered as basic instigator of other factors for economic development of countries. Investment and their efficiency determinate the capability for activation of: free labor force, disposable natural sources, transfer of technology and knowledge. Through the generated income, the part that is not spent, there is a possibility for new investment flows as a stipulation for long-term sustain of economic growth.

Investments have multiplicative impact on income growth. Namely, “increase of the investment will influence on the increase of national income more than the initial growth of investment”<sup>1</sup>. Otherwise, the decrease of investment an investment inefficiency will result with more negative impact on the national income than the initial decrease of the investment. Thence, the investment process is considered as basic, very important economy process for the engagement of beginning capital goods and labour force with the positive influence on the engagement of additional labour force and capital, or their suspension, depending on investment efficiency.

### **1. INVESTMENT ACTIVITY IN THE REPUBLIC OF MACEDONIA**

Republic of Macedonia as an economy in transition, has to put a special point on the investment in transfer of technology and knowledge from developed countries, opening and starting of new capacities in different attractive sectors, reconstruction and enlargement of existed one, as well as on the efficiency of long-term investment, for future positive contribute and effects on the whole economy. Only, investment efficiency will lead to permanent development of the economy. That's the point of interest for both, the national economy and investitures, whose are reducing current consumption of available sources for the better financial and other effects in the future.

Investment in capital funds means to make and investment in exchange and extension of fixed assets and in increase of permanent current assets. That's the gross investment category. Gross investment are usually financed from three main sources: depreciation of fixed capital, domain and foreign (imported) accumulation.

According to the official statistical data, in the last four years (2007-2010) realized payment for purchasing of fixed capital assets for all legal

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<sup>1</sup>Metodija Nestorovski: “Ekonomija na investiciite”, Ekonomski fakultet-Skopje, 2005, pp.58.

entities is mainly from own financial assets. Participation of this source is from 59,56% to 69,62% in total payment for this purpose. Next, it can be mentioned the use of financial loans, that are from 19,25% to 26,81% in the analyzed period. Financing of gross fixed assets from joint assets, assets of social funds, government and municipal bodies is between 0,49% and 13,1% from total used sources<sup>2</sup>.

In this article, only investment in fixed assets are taken into account, from at least two reasons: first, problems with evaluation of current assets, especially in part of their growth, and second, the participation of current assets investment in GDP is very low (1-3%) and they are not considered as important segment in analyzing of investment in national economies. One of the important indicator for investment in Macedonian economy is their share in realized GDP (Table 1).

**Table 1: Participation of investment in GDP in the Republic of Macedonia in %**

<i>Years</i>	<i>Participation of investment in GDP</i>
<b>2005</b>	17,1
<b>2006</b>	18,2
<b>2007</b>	20,2
<b>2008</b>	21,0
<b>2009</b>	19,9

Source: Own calculations on the basis of official data from Statistical Yearbook of the RM for appropriate years and Statistical Review: National Economy and Finance number: 3.4.8.05 (610); 3.4.9.05 (642); 3.4.10.03 (672); 3.4.11.04 (704), State Statistical Office of the Republic of Macedonia.

Official data for the share of investment in GDP, in the analyzed period of last five years is around 20%. It can be mentioned that increase of investment in 2007, is notable. The reason for that can be found in more dynamic increase of investment on one hand, than the increase of GDP for the same year, on the other. In the last year of the analyzed period, the share of investment in GDP is lower than the 2008 due the stagnation of GDP in this year and significant

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<sup>2</sup> Own calculations on the basis of official data from State statistical office, Statistical Review: National Economy and Finance for appropriate years.

decrease of investment activity in the same time. Reasons are different, but surely main reason is closely related to world economic crisis and its negative effects on macedonian economy, mostly recognized in bad working conditions for macedonian business entities and decrease of whole economic activity in that period.

Low participation of investment in GDP, as well as the low level of GDP, drive at the reasoning that Republic of Macedonia is far away from possibility for dynamic economic development. Insufficient level of investment is determined from different factors as: insufficient economic development and decreased opportunities for creation of accumulation for that purpose, low level of private saving and saving of entities, high price of investment loans and insufficient information for different possibilities for investment, system stability in transition period and possibility for risk emerging in different fields of working as for the domestic and foreign investors, too. In this circumstances, it can be considered that investment activity in the Republic of Macedonia is very low. If it is taken into account the importance of investment activity and investment participation in GDP of developed countries, which is approximately over 20% for years, for the Republic of Macedonia as economy in transition it should more than just a significant question. With the low level of investment consumption and high level of capacity obsolescence in Macedonian economy on one hand, as well as the participation of depreciation in GDP on the other hand, it is clear that in one longer period of time, Macedonian economy is on the border of disinvestment<sup>3</sup>.

Following, table 2 shows comparable ratios for participation of investment and depreciation in GDP.

**Table 2: Participation of investment and depreciation in GDP in the Republic of Macedonia in %**

<i>Years</i>	<i>Participation of investment in GDP</i>	<i>Participation of depreciation in GDP</i>	<i>Rate of investment</i>
<b>2005</b>	17,1	18,1	-1,0
<b>2006</b>	18,2	17,0	1,2

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<sup>3</sup> In case when the value of gross investment is lower than the depreciation value it is known as disinvestment. In those situation the present funds can't be exchanged and already created funds are spending, also. So, the question is weather the produced national resource can be maintained. Disinvestment can be an exception in some years (phases of development), but as a long-term process can't be endured by national economies.

<b>2007</b>	20,2	18,4	1,8
<b>2008</b>	21,0	15,9	5,1
<b>2009</b>	19,9	18,0	1,9

Source: Own calculations on the basis of official data from Statistical Yearbook of the RM for appropriate years and Statistical Review: National Economy and Finance number: 3.4.8.05 (610); 3.4.9.05 (642); 3.4.10.03 (672); 3.4.11.04 (704), State Statistical Office of the Republic of Macedonia.

Data in table lead to awareness for the low rates of investment in the Republic of Macedonia. The situation is especially insufficient in 2005 when there is a disinvestment rate and in other years Macedonian economy is on its border with the tendention of small growth. Exception is 2008 when Macedonian economy has achieved the rate of investment of 5%, but the world crisis has stopped the arise of investment rate and dropped it on 1,9% (the same level as in the year before the crisis) Rate of investment about 1-2% can not be assumed as base for long-term development of economy. This scope of investment consumption is characteristic for so called zero economic growth, that is not a fundament for stabile economic system with favourable clime for investment. Additionally, the weakness of the system in a longer period of time, is still influencing the decision making for investment and investors are calculating with high level of risks for investment on one hand, and their efficiency, on the other. In last few years, there are positive, good measures on macro level included in government investment policies for making Macedonia attractive country for investment, but the effects from those steps, based on a different types of cost-benefit anaylises for investment efficiency, will be viewable in future, on a longterm period.

## **2. DIFFERENT ASPECT OF GROSS FIXED CAPITAL FORMATION IN THE REPUBLIC OF MACEDONIA**

### **2.1 Gross fixed capital formation by purpose of investment in the Republic of Macedonia**

Taking into consideration the investment conditions, it is important to have on mind the structure of investment allocated in deferent sectors of the Macedonian economy. The fact that separate sectors (for example, industry) are in a disinvestment process for a longer period of time, as it should be a leading sector in development process, additionally is stressing the importance of this analytical approach. For that purpose, investment data in next table are structurated according to economic sectors (Table 3).

**Table 3: Gross fixed capital formation by purpose of investment in the Republic of Macedonia in %**

Sector	Years			
	2005	2006	2007	2008
<i>Agriculture, hunting and forestry</i>	3,28	3,59	2,71	2,89
<i>Fishing</i>	0,00	0,00	0,00	0,00
<i>Mining and quarrying</i>	0,79	0,67	1,46	0,84
<i>Manufacturing</i>	15,95	12,62	14,52	15,60
<i>Electricity, gas and water supply</i>	6,37	9,64	6,92	13,95
<i>Construction</i>	33,83	35,47	34,30	26,43
<i>Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods</i>	10,46	9,80	9,36	8,24
<i>Hotels and restaurants</i>	3,50	2,81	2,78	1,60
<i>Transport, storage and communication</i>	13,02	13,43	13,21	12,31
<i>Other sectors</i>	12,81	11,97	14,74	18,14
<b>Total</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>	<b>100,00</b>

Source: Own calculations on the basis of official data from Statistical Review: National Economy and Finance, number: 3.4.8.05 (610); 3.4.9.05 (642), State Statistical Office of the Republic of Macedonia.

Taking into consideration that the available official data for last two years (2009, 2010) shows different approach of classification of sectors in the Republic of Macedonia than the previous period, in the next table (table 4) are presented data for gross capital formation by purpose of investment for 2009 and 2010.

**Table 4: Gross fixed capital formation by purpose of investment in the Republic of Macedonia in %**

Sector	Years	
	2009	2010
<i>Agriculture, Forestry and Fishing</i>	3,71	2,84
<i>Mining and Quarrying</i>	0,54	0,75

<i>Manufacturing</i>	<b>17,73</b>	<b>12,45</b>
<i>Electricity, Gas, Steam and Air Conditioning Supply</i>	<b>8,93</b>	<b>8,53</b>
<i>Water Supply; Sewerage, Waste Management and Remediation Activities</i>	<b>2,52</b>	<b>5,35</b>
<i>Construction</i>	<b>29,92</b>	<b>34,67</b>
<i>Wholesale and Retail Trade; Repair of Motor Vehicles and Motorcycles</i>	<b>7,68</b>	<b>9,71</b>
<i>Transportation and Storage</i>	<b>2,59</b>	<b>3,74</b>
<i>Accommodation and Food Service Activities</i>	<b>3,18</b>	<b>1,28</b>
<i>Other sectors</i>	<b>23,20</b>	<b>20,68</b>
<i>Total</i>	<b>100,00</b>	<b>100,00</b>

Source: Own calculations on the basis of official data from Statistical Review: National Economy and Finance number: 3.4.10.03 (672); 3.4.11.04 (704), State Statistical Office of the Republic of Macedonia.

In spite of different classification approach 2005-2008 and 2009-2010, general conclusion is that for the whole analyzed period investment in economic sector is around 80% and the rest of around 20% refers to the investment in other sectors. Dominant share of investment is in the construction sector approximately 30%; next is manufacturing sector with average share of 15%; transport, storage and communications sector is participating with around 13% in the period 2005-2008 and in the last two years of the analyzed period on this level of participation is sector of Electricity, gas, steam and air conditioning supply. After that, wholesale and retail trade, repair of motor vehicle, motorcycle and personal and household goods are participating with approximately 10% (2005-2008), and the same sector without personal and household goods has the share of investment of approximately 8% (2009-2009). Furthermore, insignificant participation of investments in total investment in the Republic of Macedonia are marking: agriculture, forestry and fishing sector, hotels and restaurants or accommodation and food services (according to new classification), and other sectors. It can be mentioned that there aren't significant changes in the sector structure of investment in the period 2005-2010. If we take into consideration that construction sector is the leading one, surely most of the investment should be allocated in building of new and revitalization of current production capacities, in spite current situation when the most of investment in construction sector are allocated in housing projects. Those investments have positive impact on economic growth, but those effects will be more stimulating if they are directed to building of industrial capacities.



## 2.2 Gross fixed capital formation by type of ownership in the Republic of Macedonia

Other aspect of investment structure is the gross capital formation by type of ownership in Macedonian economy (table 5)

**Table 5: Gross fixed capital formation by type of ownership in the Republic of Macedonia in %**

Years	Type of ownership			Total
	State	Private	Other	
2006	25,5	62,7	11,8	100,0
2007	20,0	79,9	0,1	100,0
2008	23,9	76,0	0,1	100,0
2009	26,1	73,9	0,0	100,0
2010	33,8	66,2	0,0	100,0

Source: Own calculations on the basis of official data from Statistical Review: National Economy and Finance number:: 3.4.8.05 (610); 3.4.9.05 (642) 3.4.10.03 (672); 3.4.11.04 (704), State Statistical Office of the Republic of Macedonia.

As it can be seen, investment in private owned enterprises are dominant compared with those of state ownership, for the analyzed period. If the share of investment in private sector is 62,7% in 2006, in 2008 it has arised on 76% that is increase of significant 14 procent points. The arise of investment in private owned enterprises in the first three years is significant for more favourable structure of investment from this point of view, but at the same time it doesn't mean investment efficiency in the same sector. Reasons for that can be found in the number of enterprises in Macedonian economy that is in private ownership, new business with contemporary technique and technology etc. In the next two years, data show that there was a decrease of investment in private sector on 73,9 in 2009 and 66,2 in 2010. State tried to compensate this drop of investment in private sector with the investment in state owned enterprises. Significant share of approximately 36% in total investment are in companies with state ownership. For the all anaylized period, investment in state owned companies are marking small, but permanent increase from year to year. Surely, it can be concluded that world crisis had a negative impact on investment activity in private sector in Macedonian economy and reduced the investment for 10 procent points compared with 2008. Investment in other, mixed and cooperative

enterprises are insignificant in the last four years of the analyzed period due to ownership restructuration in the recent period.

One of the point of transition period was to increase the investment in private sector that is expected to be more good input for more efficient investment activity in whole Macedonian economy. As for that, we still need more investment, better level of share of investment in GDP of the Republic of Macedonia, and higher rate of investment. These are indicators that are not favourable for development of Macedonian economy. The rate of investment shows that we have not opportunity for engagement of new labour force in the economy, building of new capacities in the sectors that are interesting, attractive and should be leaders in the economy. For that aim on the long-term, it is very important to go ahead with making better investment circumstances and good investment policy on the macro level to attract foreign investment.

## **CONCLUSION**

Presented data in this paper, as well as a current level of economic development of the Republic of Macedonia indicate need for improvement of investment clime in the country and accomplishment of greather scope of investment and their allocation in those sectors of the economy which will generate higher rates of growth. That means improvement of investment structure and allocation of investment in real sector of economy, through stimulation of private domestic and foreign investors. Direction of investment in private sector doesn't mean submission of positive influence on Macedonian economy, so very important question is investment efficiency at the same time.

With activities related to undertaking measures as: government support for improvement of investment clime, making attractive investment opportunities, protection of investors, on the long run there should be expectations for larger scope of investment, needed level for better economic development. Furthermore, investors are permanently doing efforts to choose the best investment alternative, so improvment in investment structure from different aspects is anticipatory, also. That should lead to higher rate of investment efficiency in macedonian economy, with more expressive multiplicative influence on growth of income.

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**Original scientific paper**

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**HUMAN RESOURCE MANAGEMENT DURING  
RECESSION IN TRANSITION ECONOMIES:  
CHALLENGES AND PROSPECTS**

**Abstract**

Current economic conditions create challenging environment for organizations which significantly affects the way companies manage their workforce. Globally, companies struggle to survive in this uncertainty with cost cutting measures that inevitably affect their HR policies and practices. This raises issues related to the implications of the recession for HR function, the challenges that HR professionals face during crisis and HRM benefits for companies in overcoming the crisis. Taking into consideration the infancy of HRM function in transition economies, this economic crisis is expected to hinder the development of HRM, mainly due to ignorance about potential significance of strategic HRM in times of crisis. Therefore, HR professionals should be acquainted with HR measures undertaken in companies in developed economies.

**Key words:** human resource management, HRM function in transition economies, economic crisis and recession

**JEL classification:** M50

**Introduction**

People and people management are increasingly seen as key elements of competitive advantage. The complexity of contemporary business has generated the need for shaping new mindsets and proactive attitudes of the companies, as well as orientation towards greater emphasis on effective deployment of human resources. With this increase in importance of human resources in the modern business world, the HRM function gained strategic importance. Achieving

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competitive advantage through human resources requires strategic perspective which has generated a need for a formal, systematic and long term view of the management of human resources. (Boxall and Purcell, 2003).

The new interest in human resources as a strategic lever, which has emerged in the last two decades, suggests that HRM contributes directly to the implementation of the operating and strategic objectives of firms. Companies in developed economies have created complex HR systems to strategically manage their workforce in achieving company's sustained competitive advantage. A properly developed HR system creates value when it is incorporated in the operational systems of an organization in a way that it enhances the firm's capabilities. Such a system is difficult to imitate due to lack of understanding of the precise mechanisms by which the interaction of human resource practices generate value. In many companies, people are critical resource and organizational success largely depends on them.

The ongoing economic downturn, however, has profoundly changed business conditions and companies seek to make adjustments so that their internal structures, including the ways in which people are employed are aligned with the new realities. The economic crisis has spread rapidly to all countries, company markets have shrunk and sales have decreased, thus deeply affecting the performance of companies. The crisis that marks the global economy in recent years has set new challenges to the HRM professionals. While the businesses are facing dramatically reduced sales and profits, the HRM function is expected to play a key role in developing and retaining talent, controlling and reducing costs and aligning its activities with the business strategy.

## **HRM IN TRANSITION ECONOMIES**

The HRM function is in the midst of development in most of the transition economies. For more than a decade, the transition economies of Southeast Europe were characterized with high rates of unemployment, which has led to a decline of the internal power of companies' personnel departments. The large percentage of unemployment directly affected people management policies, i.e. labour surplus influenced recruitment, training, compensation, and retention policies. Additionally, the results of the privatization process, as for example job insecurity, have reduced the power of unions with direct effect of weakening the industrial relations. Also, the lack of HRM tradition additionally hampered the development of HRM during and after the transition period.

The transition from centrally governed to market economy, which mainly occurred during the 1990s, prompted companies' need to stay competitive and survive in the ever challenging business environment. However, most companies are still tackling acute financial problems, and focus on renewal of

obsolete technology and reduction of costs as a response to stronger competition. In this regard, HRM has been completely neglected and even today many companies do not consider HRM to be a significant source of competitiveness nor do they consider the potential impact of HRM strategy on employee and company performance. This has made the understatement of the HRM function in companies in transition economies become a chronic issue. Recent research (Bogićević et al., 2008; Zupan & Kaše, 2005), however, has shown that HRM function has started developing, primarily concerning policies on recruitment, employee training and development, performance management and compensation.

The small percentage of medium and large companies that have developed formal proactive policies of HRM does not contribute significantly to the development of the HRM on strategic level. The literature confirms that the size of organizations influences the development of HRM systems and practices at a national level (Sparrow & Hiltrop, 1997). In this regard, the prevalence of extremely small companies, specifically family-owned, in the transition economies of Southeast Europe has restricted the development of strategic HRM and its role in the companies. On the other hand, the foreign direct investments had a positive impact on HRM development in transition economies. A more significant transformation of the HR function is usually undertaken in foreign-owned companies that transfer their own HRM models and practices (Kiriazov et al., 2000). In the foreign subsidiaries of MNCs, the reforms in selection procedures, compensation and performance management systems are the first steps taken by HR departments, and are primarily used as instruments for creating a new corporate culture (Taylor and Walley, 2002). These modern HRM models are then often disseminated to the domestic sector consequently boosting HRM development.

The survey on HRM practices and the degree of their development in transition economies (Bogicevic et al., 2008) shows that human resource management is still underdeveloped compared with EU countries. Namely, it is identified that HRM function does not have significant impact on strategy formulation in companies; HR managers have inadequate competences; most companies are characterized with low level of communication between management and employees and there is a lack of employee participation in decisions and company policies. Recent research of the existing HRM practices (Majovski, 2010) revealed that mostly developed practices are those of rigorous selection and pay-for-performance. Indeed, the main HRM practices observed are: rigorous selection in employment, built system of performance-related pay, formal training of employees in several areas, and career development opportunities. On the other hand, companies are characterized by centralized decision making, low level of employee participation and low impact on company policies. Decisions regarding HRM issues are also highly centralized.

In general, the level of development of HRM systems and practices in transition economies of Southeast Europe is far lower in comparison to the EU and US systems of HRM. The analysis of HRM systems that are implemented in companies in transition economies and developed economies point to the existence of differences in the role of HRM in companies and in the strategy creation, the organizational level at which important HRM decisions are taken, systematic planning and organizing employee training and development, performance management, pay-for-performance system, employee participation, and the union power (Bogicevic & Janicijevic, 2009). Rigorous selection, pay-for-performance systems and training, as one of the first HRM practices implemented during corporate change are not sufficient to construct a strategic HRM. This implies that companies in transition economies still cannot derive all benefits from their human resources and they lack a strategic insight into HRM.

### **THE IMPACT OF RECESSION ON THE HRM FUNCTION**

The undergoing recession has raised a great deal of debates and comments about the possible effects on human resource management and potential areas for action as pay cuts, reduced hours, redundancies, the retention of key talent and nurturing employee commitment. Some research has been conducted in developed economies on ways in which HR managers handle the recession and the way they will be affected by it.

The ongoing severe economic crisis impacts not only the market performance of the companies but also the way things are carried out in organizations. The HRM function faces numerous organizational and financial obstacles in times when its strategic role should be confirmed. Tackling the financial problems and decreased market performance that companies face during recession, and in order to put costs under control, companies usually react by cutting employee hours, ceasing recruitment, compensation cuts and even layoffs. Generally, major HRM areas that are primarily affected in times of economic crisis refer to compensation and monetary rewards, training and development opportunities and retention of key employees.

In economic downturn, many companies insist on short-term cost-cutting measures as reducing employee training, additional compensation benefits in order to avoid major staff layoffs. Costs related to funding development opportunities are always a concern for management in difficult times and thus, many companies are reluctant to continue to provide development opportunities to their employees. However, the recent research conducted by the Institute of Behavioral Science (Moore et al., 2003) calls on precaution with these types of cost-cutting measures, as workers who survive company layoffs and pay

reductions were found to have higher levels of depression, which subsequently reflects on their work performance. Therefore, organizations should act in turbulent times in direction of improving employee morale and retaining key employees.

King's College London & Speechly Bircham (2010) research on the effects of the recession on HRM and companies' responses highlights similar findings among UK firms. The recession has affected more HR practices with reductions in pay rises, size of bonuses, training and development budgets and the staffing levels. Companies however tend to use flexible and part-time working in order to avoid compulsory redundancies. Nevertheless, the economic crisis has impacted the workforce in companies with increase in levels of stress among employees. Therefore, the major HR challenge in UK firms is maintaining employee engagement through more effective leadership and staff management, developing better employee relations with line managers. There is also an evident need for HR to focus on the role of line managers to make more effective attempts in raising levels of employee engagement and performance.

A survey of more than 3.348 executives in more than 30 European countries and more than 15 industries by The Boston Consulting Group (BCG) and the European Association for People Management (EAPM) (Strack et al., 2009) shows similar results with regard to actions taken by companies. Among the identified primary actions taken during the current recession are cutting back on recruiting, on company events and on bonus payments tied to company performance. The latter, however, is confirmed to undermine employees' commitment to their company. What is interesting in the findings is that companies have given priority to temporary and full-time employee layoffs over cutting back on training and using early retirement. This is mainly because the cuts on individual and functional training were least effective in the previous recession and had negative impact on employee commitment. On the other hand, the most effective action with positive impact on employee commitment is layoffs based on individual performance. That is, the underperformers are the ones made redundant, whereas high performers are rewarded with job security. Nonetheless, due to the demographic changes and the foreseen talent shortage, many strategically long-term-oriented companies continue to recruit new employees amid the economic crisis.

During recession, companies pay insufficient attention to retaining their talent pool. Focusing on short-term strategy to respond to the uncertainty and imposed changes, companies tend to avoid undertaking present action to support long-term strategy. Put simply, coping with current challenges and reactive cost-cuttings through major layoffs and significantly reduced employee



development programs can undermine the future competitiveness of the company.

Companies in transition economies tend to neglect the HRM function in times of economic crisis. This is primarily due to lack of tradition of strategic HRM in companies, as well as lack of significance given to the HRM function by senior management. In many companies in transition economies, employees are still considered a cost rather than an asset, and the phrase 'Employees are our most valuable asset' remains only to be a saying. The reality, however, shows that the employees are the first to be hit by the crisis. Traditional firms in transition economies are more likely to implement full-scale cost-cutting strategies in almost all HR practices and activities.

An in-depth research on the effects of the recession on HRM function in companies in transition economies have not yet been conducted, nor about the potential actions that HRM professionals are undertaking to tackle the challenges they face. However, taking into account the recent situation in HRM in companies in transition economies, one would presume that the situation leaves a lot to be desired. Unfortunately, many companies will fail to use significant HRM tools and measures, due to lack of experience or knowledge, which could prove fatal to the very existence of the organization in such large-scale crisis. Hence, for the companies in transition economies it is paramount to know the preferred HRM actions that are undertaken as a response to the ongoing recession.

## **THE ROLE OF HRM AMID THE ECONOMIC CRISIS**

The significant role of the HRM function is indeed biggest during turbulent times, rather than during times of prosperity. The changes in markets might pose not only a need for cutting costs but also for shifts in corporate strategy and direction. In this regard, HRM should craft specific policies and practices as a response strategy to the changing circumstances.

A research conducted in 35 companies in US by CAHRS in 2009 (Fitzpatric et al., 2009) identified four overall engagement concerns of management: keeping employees focused amid external and internal distractions, supporting employee well-being, managing and preserving talent, and messaging appropriately to both provide reassurance and protect the employer-employee bond. In order to overcome these challenges, companies are implementing several strategies referring to increased communication, additional direct support for managers, enhancing connections between employees and the organization, continuing a small number of business as usual activities and common-sense actions specific to the situation of a particular firm and the needs of its workforce.

The external pressure from the economic environment, emphasized by media hype about deep recession and rising unemployment, as well as the internal pressure arising from reduced market performance of companies and potential financial obstacles which generally result in reduction in employee compensation and benefits and even increased layoffs induce uncertainty among employees regarding their job security and financial stability which subsequently affects employees work engagement. Therefore, the priority of companies should be engaging employees, maintaining their morale as well as keeping them focused and productive. Employers in developed economies attempt to identify major employee concerns and their impact on employees' day-to-day work in order to implement appropriate HR measures and keep their employees highly productive as a basic necessity in surviving the turbulent times.

Regardless of how trivial it sounds, especially to managers and companies in transition economies, communication is identified as key instrument in times of crisis. Communicating how the external environment affects the strategy, the financial state and viability of the company, as well as proposed measures to coping with the current situation is the preferred HRM measure to maintain trust among employees and engage them in overcoming the challenges. Research (Fitzpatrick et al., 2009) shows that the most common way of coping with employee engagement challenge is increased communication with employees. Increased internal communication related to difficult economic climate and undertaken cost-cutting measures will foster credibility with the workforce.

In a survey undertaken by CIPD (2009), almost 65% of the employers stated improving internal communication as the predominant strategy used to improve employee engagement and performance during the crisis. This, however, does not imply only downward communication, as the upward communication is as much significant in overcoming the uncertainty and anxieties among employees, as well as increasing their morale. The internal communication is probably by far the cheapest and most effective measure in times of crisis. In fact, the employer-employee relations during turbulent times have direct impact not only on present, but more importantly on future employee motivation levels.

Companies in developed economies do not focus only on soft HR practices as improved communication, employee engagement and high employee morale levels in times of recession. Namely, The Economist Intelligence Unit (2009) survey revealed that top priority of companies in this period is also effective quantitative metrics-based performance management and boosting productivity without increasing costs. Many companies today are working with fewer resources than in the past and with the current economic

crisis the primary focus of companies is on gaining productivity at low cost. Surveyed companies identify four methods that are successful in gaining additional productivity from employees, without raising compensation costs, as creating additional training programs, adopting more efficient methods of service delivery, more rigorous performance evaluations and mentoring programs.

The issue of pay levels and key talent retention is equally important aspects considered by companies. As pay rates suffer most in times of crisis, companies are seeking alternative ways to retain their key talent. At the same time, due to the crisis, companies are facing situation of presently overstaffed, in comparison to their current scale of production. However, many companies that focus on their long-term strategy are looking for ways to retain their talent with the capacities necessary for the future post-crisis period. The actions taken in past recessions, focused on freezing recruitment and employee layoffs have left companies with a talent shortage, which had additional implications on their post-crisis performance.

HRM can be invaluable during current crisis by building relationships with employees and finding innovative ways to retain programs and practices, as training, career development and succession planning, which are fundamental to the company. The main challenge of the HRM function in uncertain times is to balance the long-term and short-term strategy of the company. While using short-term strategy to cope with existing difficulties, companies should consider a long-term outlook to be prepared for the post-recession period. As such, companies continue to invest in processes and practices that will nurture the long-term prospects of the organization and its talent pool. This, however, is not the case with companies in all countries. Namely, a recent research (Fodor & Poor, 2009) shows that companies in Hungary and Slovakia tend to avoid layoffs but also are highly reluctant to innovate in the HR field as they do not relate it to the solution of the crisis. In fact, many companies in these countries do not see knowledge management as a tool that can benefit them during crisis.

Research related to HRM and the recession (Roche, 2011; Fitzpatric et al., 2009; Strack et al., 2009) shows that, in the preceding and following years, the main focus in organizations remains both on hard and soft HR practices. In majority of the companies, hard HR practices mainly relating to reduction on pay and bonuses, workforce reductions, cuts in working time, constrains on recruitment and promotion, and productivity measures prevail in order to achieve cost reduction. However, the cost reductions achieved with the hard HR practices should not be at the expense of a severe loss of motivation and commitment among employees. In Ireland, during the economic crisis, the influence of HR on business decision-making has increased as many firms have become dependent on HR knowledge and response measures for survival

through the recession (Roche, 2011). The HR in Irish companies has contributed in a major way to companies' response strategies and working with line managers to facilitate the implementation of response measures. Namely, many companies have also focused on soft HR practices as increased communication, fostering employee engagement, and training and talent management programs, aimed at maintaining motivation and commitment among employees.

## **CONCLUSION**

The HRM has a critical role during economic crisis as it faces huge challenges while seeking to create value in such turbulent times. In order to achieve the desired goals, the HRM professionals should strategically approach the issues of employee planning, keeping employees informed, focused and engaged, and even restructuring the organization. Ultimately, it is in the times of economic crisis that the HRM should demonstrate its significant role in company's performance. The major challenge of HRM during uncertainty is balancing between short-term and long-term strategy. While coping with existing difficulties through cost-reduction plans, companies should also consider long-term plans and strategy in order to be prepared for the post-recession period.

In developed economies, there is an acute awareness amongst many employers that in responding to the crisis they have to develop strategies that combine initiatives to reduce costs with measures to improve innovation and quality, employee morale and engagement. As a result, the main focus in organizations is both on hard HR practices (relating to reductions on pay and bonuses, workforce reductions, cuts in working time, constraints on recruitment and promotion, and productivity measures) as well as soft HR practices (as increased communication, fostering employee engagement, and training and talent management programs).

As a result of inexperience and lack of awareness for the potential benefits of HRM during recession, it is expected that companies in transition economies will be reluctant to focus their attention on tailoring and using HR practices in overcoming external and internal challenges. Consequently, it is of utmost importance for companies in transition economies to identify and use the experience of companies in developed economies related to specific HR practices that have positive effect during recession.

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**Original scientific paper**

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## **THE RESHAPED ROLE OF SUPERVISORY BOARDS AFTER FINANCIAL CRISIS**

### **Abstract**

Good corporate governance is vital to restrict aggressive risk-taking. Weak corporate governance arrangements which have failed to safeguard against excessive risk-taking are partly to blame for the economic crisis. Such weaknesses remained hidden when the market was in expansion but the downturn has revealed a number of deficiencies. Still it is not clear if the market suffered from the “bystander effect” or perhaps the short-term profits blinded shareholders, board members, executives and others. The basic principles for self-regulation and self-correction or strict regulatory rules are now the basic two choices and their mixture will have further influence on the corporate governance in banking institutions. Supervisory Board is one of the most important internal corporate governance mechanisms with obligation to monitor and advise executive management in fulfilling the mandate to protect shareholder interest of managerial excessive. The failure to fulfill their obligations opens the question about further enhancement of their role. The aim of this paper is to summarize the lessons from the crises regarding the Supervisory Board, what are the main weaknesses and what steps should be taken. This paper also will analyze the performance of the Supervisory Boards in Macedonian banks with recommendations for their further improvement.

**Keywords:** Corporate governance; banking system; Supervisory Board.

**JEL classification:** G01, G21, G34, M14

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## **Introduction**

The fragility of the banking sector poses a risk to the real economy and any financial distress by banks carries large macroeconomic costs. That is the main reason why regulators and bankers have recognized that corporate governance plays an important role in the prudent operation of financial institutions and in the stability of the financial sector. According to Ard and Berg (2010) effective corporate governance is “the first line of defense” in the supervisory activities of the national supervisors. Good governance complements financial supervision and is an integral factor to implementing risk-based financial oversight. The Basel II Framework requires that banks maintain strong internal governance procedures and processes. Pillar II requires that banks maintain well-functioning systems of internal controls and risk measurement, management and mitigation and adequate review processes by management and directors. Several authors (Johnson, 2000; Mitton, 2002) present evidence indicating that corporate governance is of first-order importance in determining firm performance during crises. In general, the authors attribute this importance to two factors. The first is that expropriation by managers is likely to become more severe during these periods because the expected return on investment falls. The second is that during crises, the quality of corporate governance is likely to attract more scrutiny.

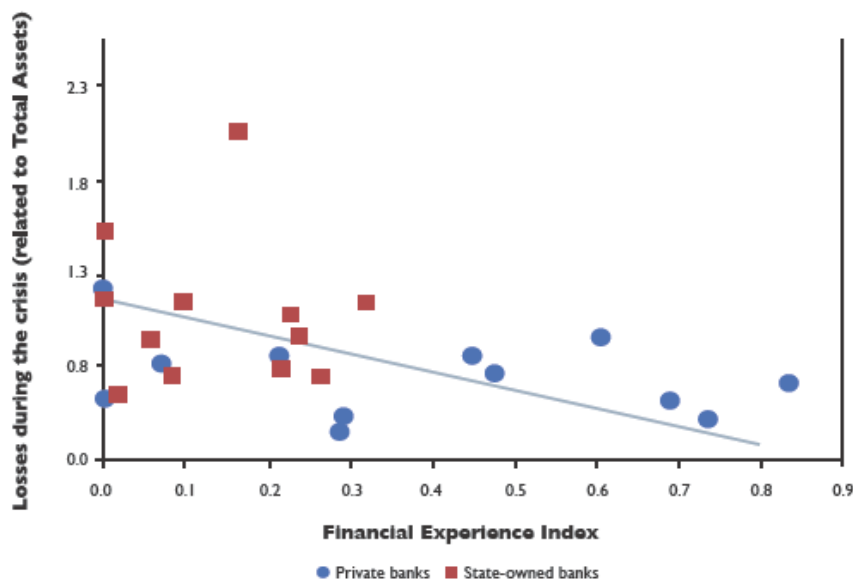
The recent financial and economic crisis refueled the debate on corporate governance as a control mechanism that failed to fulfill its responsibilities. In the wake of the 2008 financial crisis, Wall Street bankers, government regulators, academics, and the general public all asked one simple question: "Why?" The answer to this question is important to the task of figuring out how to prevent such an event from happening again. The Supervisory Board is important element of the corporate governance and its main role is to oversight all the activities of the bank. The failures in the Supervisory Board role open the key question: Were these failures the result of poor application of sound governance principles or there is a need for further strengthening in the Supervisory Board principles?

### **1. IS THERE A LINK BETWEEN SUPERVISORY BOARD AND CRISES PERFORMANCE**



A lot of studies (Aebi, Sabato and Schmid, 2011; Ladipo and Nestor, 2009) after the financial crises have been done with the main question of if there was a link between the Supervisory Board and firm performance in financial crises. The summarized results show that few questions are relevant for board crises performance: the expertise of the board members and remuneration policy, the reporting lines and board meeting frequency and director attendance behaviors. These studies should help policy makers to strengthen the rules regarding Supervisory Board.

There is strong evidence of correlation between the board competence and the crises performance. Hau and Thum (2009) use crisis-related write-downs and losses reported by the German banks during 2007 and 2008 as a performance measure. Competence is measured with 14 different biographical criteria. Result shows that a lower Supervisory Board competence in finance is related to higher losses in the financial crisis (Figure 1). The results also confirm that the financial experience is positively correlated with the crisis performance of a bank.



**Figure 1:** Subprime – related bank losses and financial experience of Supervisory Boards

The studies (Thomas, Schrage, Bellin and Marcotte, 2009) in the USA banking system confirm this fact. As it can be seen from Table 1, around 60%

of the members of Supervisory Board don't have any banking experience. What is more important around 70% of the independent board members who have key part in control of the risks that are taken, have no banking experience. Supervisory Board members who lack understanding of bank operations may be a key disadvantage in meeting their fiduciary responsibilities. Those members can become overly dependent on the representatives that are not independent. Also they don't have expertise to raise crucial questions. Board members without an understanding of bank operations can also fall into a mode of group thinking (Charan, 2009).

**Table 1 - Experience of Supervisory Board members in USA**

	<b>All members</b>	<b>Independent members</b>	<b>Nonindependent members</b>
No experience	60%	67%	6%
Some financial experience	3%	2%	3%
Some commercial banking	1%	1%	0%
Extensive financial services	18%	20%	3%
Extensive commercial banking	18%	9%	88%
Total	100%	100%	100%

Source: Robert Thomas, Michael Schrage, Joshua Bellin and George Marcotte. (2009). How Boards can be better – A Manifesto

Disagreeing with the experienced dependent members or challenging their position can present formidable obstacle. The second important aspect related to Supervisory Board performance is the remuneration policy. This question is connected with the previous one, whether greater remuneration means more qualitative board members. In particular, better paying banks could be able to attract better executives, thus yielding a better risk management and crisis performance. However, the studies (Harald and Marcel, 2009) find evidence on the contrary. The higher executive pay was correlated with higher losses during the crisis. Thus large executive pay packages signal severe agency problems rather than a better management. Also according to Basel Committee

for corporate governance, the Supervisory Board is responsible for the remuneration policy of the senior management. The research conducted after the financial crises show that CEO remuneration has not closely followed company performance. One study (Shareholder forum, 2008) reports that the median CEO pay in S&P 500 companies was about USD 8.4 million in 2007 and had not come down at the time when the economy was weakening. Also board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment. Ladipo (2008) with his study of European banks indicated that in 2006, the fixed salary accounted for 24 per cent of CEO remuneration, annual cash bonuses for 36 per cent and long-term incentive awards for 40 per cent. This might still leave significant incentives for short run herding behavior even if it involved significant risk-taking. One study of six US financial institutions found that top executive salaries averaged only 4-6 per cent of total compensation with stock related compensation hovering at very high levels (Nestor Advisors, 2009). General conclusion is that the Supervisory Board failed to link the long-term performance with the remuneration package and created incentives for excessive risk-taking.

Regarding the reporting lines to Supervisory Board, IIF study concluded that to have a strong, independent voice, the CRO should have a mandate to bring to the attention of both line and senior management or the board any situation that could materially violate risk-appetite guidelines. The after crises research demonstrated that reporting is more effective when the CRO reports directly to the Board or when the CRO had a seat on the board committee. In many cases, the CRO will be engaged directly on a regular basis with a risk committee of the board, or when there is not one, with the audit committee. Aebi, Sabato and Shemid (2011) confirm this observation and conclude that banks, in which the CRO reports directly to the Supervisory Board, perform significantly better in the financial crisis while banks in which the CRO reports to the CEO perform significantly worse than other banks. The reporting line of the CRO in particular are important to the banks crisis performance as the CEO and CRO may have conflicting interests and if the CRO reports to the CEO, the risk agenda may not receive the appropriate attention.

Adams and Ferreira (2009) argue that board meetings and the attendance at these meetings are important channels through which directors obtain firm-specific information and fulfill their monitoring role. This conclusion is confirmed by Francis, Hasan and Wu (2011). In his research he compares the stock performance through the financial crises with the frequency of board meetings. According to his research board meeting frequency is positively related to stock performance. Economically, one additional board meeting increases stock returns about 0.019. The result suggests that board meetings are an important attribute of board efficacy during the crisis. Also attendance

behavior is important for effective monitoring of bank activities. Board of directors that consist of members who lack time to carry out board duties is huge problem for proper monitoring. This is empirically confirmed and the results of Francis, Hasan and Wu (2011) indicate that firms with poor board attendance at meetings perform significantly worse than those with good attendance during the crisis.

Further enhancement of Supervisory Board activities and results can be achieved by proper board composition. Empirical studies (Berger and Kick, 2012) show that decreases in average board age robustly increase bank risk-taking. Thus board composition should be proper mix of younger and older members in order to avoid excessive risk-taking activities. Also, women representatives in Supervisory Boards contribute for better risk management and stability of the institution, thus gender mix of the board is important too. Another important aspect of Supervisory Board operation is the renewal policy for board members mandates. In order to restrict the excessive risk-taking activities and strengthens the control function it is important to avoid renewing of mandates of Supervisory Board members. In this way the board remains open to new ideas and maintains independent thinking.

Thus, further enhancement of corporate governance regarding Supervisory Board can be done by: electing members who are more specialized in banking, strengthening the role of CRO and establishing a direct link of reporting with the board and increasing the number of meetings and attendance of board members. Also special attention should be focused on board composition and member rights to renew mandate. Other question is if these improvements should be prescribed in the regulatory framework or let the banking industry itself enhance the role of the Supervisory Board.

The argument for principle based regulation is a market discipline. Market participants are constrained by market discipline in setting prices because they have strong incentives to generate revenues and avoid bankruptcy. Financial crises pointed out three exceptions to this hypothesis: the moral hazard that comes from deposit insurance system, the moral hazard that comes from lender of last resort and too big to fail doctrine. All these moral hazard issues offer incentives for the protected to behave differently – irresponsibly, carelessly or less conservatively simply because of the existence of protection (Lastra, 2006). Another problem is the principal agent problem. Banks have information advantages and this provides the opportunity to take reckless actions, and the financial crises have shown that market discipline doesn't solve this problem. The existence of information deficiencies is a good example of what prevents market discipline thus justifying regulation in the form of hard-wired rules. Although rule-based regulation does not make use of managers' expertise whereas the notion of market discipline allows firms to operate more

efficiently due to the use of managerial insights (Atsem, 2010). Another argument why market discipline provides a good foundation for regulation is because of financial innovation and technological improvements through the use of financial intermediaries. Producing and implementing “hard-wired” rules governing these activities become more and more costly to monitor and supervise from a regulatory perspective.

Taking into account all pros and cons the best way to design supervision of the financial system is to provide financial institution governance with the right incentives by setting out a number of principles, but to back these principles with a set of prudential rules and standards, and guidelines to further align managers’ and supervisors’ incentive structures (Sants, 2011). The current financial crisis, in particular, has shown that the financial system cannot survive on principles alone, without rules, which sometimes will take the form of guidelines, and sometimes need to be prescriptive.

## **2. SUPERVISORY BOARD FAILURES THAT CONTRIBUTED TO THE FINANCIAL CRISES**

According to the principles for enhancing corporate governance (Basel Committee, 2010) Supervisory Board has an overall responsibility for the bank, including approving and overseeing the implementation of the bank’s strategic objectives, risk strategy, corporate governance and corporate values. So, the board has ultimate responsibility for the bank’s business, risk strategy and financial soundness, as well as for how the bank organizes and governs itself. Also it is very important the control function of the board who is responsible for providing oversight of senior management.

Regarding its responsibility to shape the strategy of the bank (Basel Committee, 2010), the Supervisory Board should:

- approve the overall business strategy of the bank, taking into account the bank’s long-term financial interests and safety; and
- approve and oversee the implementation of the bank’s: overall risk strategy, including its risk tolerance/appetite; risk policy, risk management and internal control systems, including compliance policy; and corporate governance principles and corporate values, including a code of conduct or comparable document.

Also the Supervisory Board should monitor that senior management's actions and evaluate are they consistent with the strategy and policies approved by the board, including the risk tolerance/appetite; meet regularly with senior management; question and review critically explanations and information provided by senior management; and set formal performance standards for senior management consistent with the long-term objectives, strategy and financial soundness of the bank, and monitor senior management's performance against these standards.

Briefly the primary responsibility of a bank board is to ensure that the franchise can survive outside shocks and prosper in good times. The board's role is to rise above the technicalities of risk management and ask the big questions going forward. There were three key failings in the Supervisory Board that contributed to excessive risk-taking: the failure to perform oversight function, not understanding the risk that the banks are exposed to and the focus on risk measurement rather than risk identification.

Failures in risk assessment and risk management were aggravated by the fact that the checks and balances of corporate governance also failed (The high level Group of financial supervision in EU, 2009). The board members neither understood the risks that were hidden in the new, highly complex financial products they were dealing with, nor were they aware of the aggregate exposure of their companies. They didn't ask the basic question of what were the risks of those transactions and didn't fulfill their basic duty to determine the proper tolerance of risk. The remuneration policies approved by Supervisory within financial institutions contributing to excessive risk-taking by rewarding short-term expansion of the volume of (risky) trades rather than the long-term profitability of investments. Vice versa the pressure from the shareholders to deliver higher share prices and dividends through Supervisory Board was ported to the senior management. Thus Supervisory Boards didn't not only set appropriate limits but also encourage excessive risk-taking.

The second failure regards the fundamental failures in the assessment of risk and is closely connected to the first failure of oversight the senior management operations. The Supervisory Board misunderstood the interaction between credit and liquidity and failed to verify the leverage of banks. Although the leverage of banks was rising, the board didn't assume that this trend was a result of excessive risks. Most of the boards were content to measure performance by return on equity, earnings per share and other measures that indirectly encouraged increased leverage. Important role for this picture have had the extreme complexity of structured financial products, which made proper risk assessment challenging for even the most sophisticated in the market. The Supervisory Boards didn't understand that they were accumulating tail risk that could have tremendous effects in financial downturn. The originate-to-distribute

model as it developed, created perverse incentives. Instead of using the advantages of securitization, the way it was conducted contributed to blur the relationship between borrower and lender, but also to diverted attention away from the ability of the borrower to pay towards lending. Thus the Supervisory Boards didn't put appropriate control mechanisms in the risk identification function. This with combination of their poor understanding of risks that were taken and inappropriate measurement resulted in excessive aggregation of risks. Also the Supervisory Boards substantially underestimated liquidity risk. The maturity transformation, as the foundation for bank activities was done without proper limits. Once again the Supervisory Boards failed and approved a business model that exposed banks to high risk. What looked like an attractive business model, borrowing short and lending long, turned out to be a dangerous trap once liquidity in credit markets dried up.

### **3. THE SUPERVISORY BOARD ROLE IN MACEDONIAN BANKING SYSTEM**

In this section of the paper, the Supervisory Board role in Macedonian banking system will be analyzed, having in mind the deficiencies numbered in the previous section. The analysis will be done through evaluation of existing solutions in the laws and bylaws.

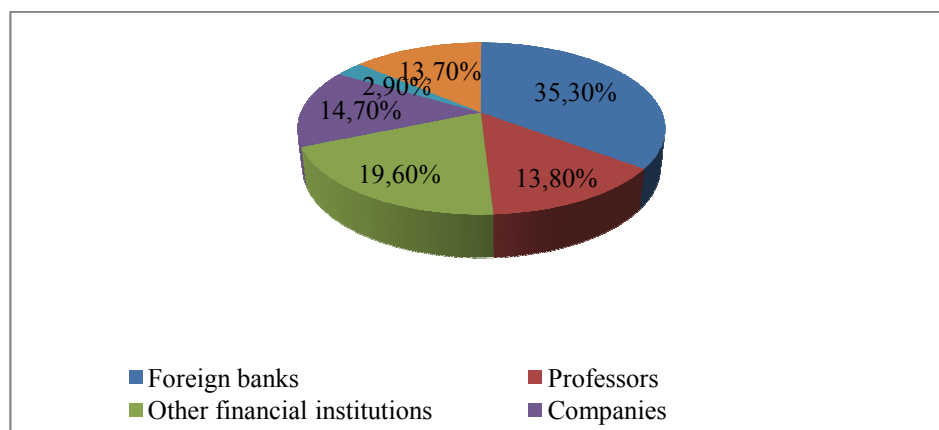
Regarding the first issue about banking experience of the Supervisory Board members, it is regulated in the Banking Law and by-laws. According to the legislation the Supervisory Board member should have appropriate qualifications which mean: university degree, at minimum; knowledge of the regulations in banking and/or finance area and knowledge of financial industry and environment the bank operates in; experience contributing to stable, safe and efficient management and surveillance of the bank operations.

Additionally, the member of the Supervisory Board should: be honest, competent, capable of giving independent assessment and have strong personal integrity; understand his/her role in the corporate governance and fulfill his/her supervisory role efficiently; know the bank's risk profile; know the regulations and take care of establishing and maintaining professional relations with the National Bank of the Republic of Macedonia and other competent supervisory and regulatory institutions; demonstrate loyalty and care for the bank; avoid conflict of interest, or possible conflict of interest; devote enough time for active fulfillment of his/her obligations; estimate the functioning of the bank's Board of Directors at least once a year, with the bank's business policy and

operating plans being the initial basis; give proposals for good corporate governance; and take no participation in everyday management of the bank.

Thus, according to the Macedonian banking legislation there aren't any strict requirements. The only thing that is prescribed is that the board member must have university degree, but the field of expertise is not defined. Further enhancement of the regulation should be done by determination of the field of expertise of the board members. Also the regulation doesn't define what is meant by experience which is even bigger deficiency than the previous ones. The regulation in this section should be concise and provide people with appropriate experience in finance to be board members. As the studies have shown this is of great importance for the performance of the bank in stressed conditions. Only member with sufficient experience can make proper oversight of the bank activities and carry appropriate decisions. The way regulation is set now, without enough concise criteria, can lead to risk, the National Bank to issue approval to a member, which will contribute negatively to bank activities. The decisions will be made with all the consequences and it will be late to withdraw the approval.

At the end of 2011 Supervisory Boards of the Macedonian banks comprised of average 6 members (NBRM, 2012). Most of the members (43%) of Supervisory Boards are representatives of the foreign mother banks. Bearing in mind the legal requirement for independent members, 34% of all members of Supervisory Boards in Macedonian banks are independent. Regarding the professional experience of the Supervisory Board members, most of them or around 35% come as representatives of foreign banks (Figure 2).



**Figure 2:** Structure of Supervisory Boards in Macedonian banking system at the end of 2011



Regarding the second issue about the reporting lines to Supervisory Board, minimum reports are defined in the Banking Law. According to the Banking Law the Supervisory Board discusses the reports on the activities of the bank's Board of Directors, Risk Management Committee, the Auditing Committee and Compliance Officer; discusses the supervisory reports, and undertakes measures and activities for addressing the identified shortcomings and weaknesses in the bank's operations and discusses the report of the auditing company and submits written opinion thereon to the General Meeting of Shareholders.

Thus, the CRO should have a mandate to bring to the attention of both line and senior management or the board any situation that could materially violate risk-appetite guidelines. The after crises research demonstrated that reporting was more effective when the CRO reports directly to the Board. The key areas for further strengthening of corporate governance in Macedonian banking institutions need to be addressed in regard to increasing the quality and effectiveness of Supervisory Boards, to devote enough time for active fulfillment of their obligations as well as the mechanisms for their effective oversight and evaluating the results of the bank's operation, increasing the importance of internal controls and risk management system.

## **CONCLUSION**

Further enhancement of corporate governance regarding Supervisory Board can be done by: electing members who are more specialized in banking, strengthening the role of CRO and establishing a direct link of reporting with the board and increasing the number of meetings and attendance of board members.

Taking into account all pros and cons the best way to design supervision of the financial system is to provide financial institution governance with the right incentives by setting out a number of principles, but to back these principles with a set of prudential rules and standards, and guidelines to further align managers' and supervisors' incentive structures. The current financial crisis, in particular, has shown that the financial system cannot survive on principles alone, without rules, which sometimes will take the form of guidelines, and sometimes need to be prescriptive.

Further enhancement of the Board role is determination of the field of expertise on the board members, board composition and member rights to renew mandate.

The development of the practices of good corporate governance is a dynamic process. Continuing changes in financial markets inevitably lead to a revision of the existing regulation and practices. Banks and regulatory institutions must constantly learn by previous experience and look to enhance the regulation and practices and to try to find better ways to strengthen the role of the Supervisory Board in order to maintain bank stability.

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**Original scientific paper**

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**ALTERNATIVE FORM OF MAPPING POTENTIAL  
AND ACTIVE SMALL BUSINESS AGGLOMERATION**

**Abstract**

Clusters, concentrations of businesses and research institutions, show high capacity for job creation, innovativeness and development. They can also, foster the access to the EU development funds. However, in the case of small business, their early tracing can be very difficult with top-down methods. The statistical activity code mapping, fairly appropriate for big industries, fails due to the apparent discrepancies between the registered and the actual activity of the small businesses. In addition, these clusters are often built around focal firm located out from the region in focus.

We surveyed concentrations of small businesses in three regions in Macedonia using structured focused groups. We relied on the capacity of the local business support and regional development agencies and the institutions of higher education in these regions, infrastructure established with prior programs of the Government, and various donor agencies. We managed to discover several existing and potential small business clusters that should be further supported by the related national policy. Since the structure of the small business support network is similar, we conclude that this approach can prove useful in other countries and regions, with similar business development services network.

**Key words:** Clusters, Industrial Policy, Development, Innovativeness, Competitiveness

**JEL classification: M21, O11, R11, R12,**

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## 1. INDUSTRY CLUSTERS AND THE DEVELOPMENT POLICY

*Since the Alfred Marshall's notion that the development of industrial complexes can be attributed to the existence of positive externalities in agglomerations of interrelated firms and industries, also known as The Cluster Hypothesis, (Marshall, 1920), the various forms of industry clusters constantly attract scholars, businesses and policymakers (Peneder, 1997). Significant impetus to this trend was provided by Michael Porter. He noticed, while surveying the differences in the competitiveness between firms and regions, that the spatial concentrations of enterprises, specialized vendors, universities, research and development institutions that are interrelated and closely cooperate can significantly foster the competitiveness of the businesses involved, the regions and the states where they operate (Porter, 1990). However, he stressed that the proximity (the spatial concentration) works only in combination with the availability of specialized vendors, suitable workforce and only if the process requires an intensive interaction between the companies (Porter, 1998).*

Porter also emphasized the reinforcement of the competitive process and the business rivalry that results from the concentration. He also stressed that, once established, the cluster turns into a driver of even bigger concentration. The process of formation of industry clusters is similar to the process of formation of new planets from scattered stellar material. It takes considerable time the concentration of the matter to reach the critical point. However, beyond that point, the concentration inevitably results in a cluster of planets. Moreover, the concentration does not stop and ultimately limits the number of planets, since the smaller simply merge with the bigger! This explains the results of some statistical surveys that showed that the large establishments repel, rather than attract their industry kin. In other words, the spatial concentrations could, in fact lower the firm formation rate relative to dispersed industries (Perry, 1999).

The interrelation with the knowledge is additional important virtue of the clusters. In fact, they are often seen as business communities, specialized in efficient knowledge creation and transfer (Morosini, 2003). It is believed that the clusters help the development of unique knowledge and skills, some kind of shared set of core competencies, difficult to replicate out of that unique agglomeration. In addition, the information and knowledge are easily shared, and the interaction with the academia and research institutions is much less formal and much more flexible within the cluster.

Many scholars and practitioners stress the trust and the cooperation that exists between the businesses in the cluster as its main asset: the trust is the glue of clusters (Pezzi, 2009). Within the cluster environment, businesses are

encouraged to specialize and to use subcontracting to provide flexible economies of scale and scope with considerable capacity for innovation. The fast dissemination of the knowledge and the close interactions with the customers create more ideas and a pressure for further innovation since the cluster environment lowers the formation costs and allows business experiment and trial. The financial institutions (banks, seed and venture capital) are more open to the cluster members than to the companies outside such agglomerations. They believe that these companies have more chances to be successful, because they are collocated in a cluster, thus creating a positive feedback: the survival ratio of the small businesses within a cluster, *inter alia* thanks to this better access to the funding, really tends to be higher, than the average. Steinle and Schiele argue that the isolated firms could have up to 40% lower returns, than their counterparts from some form of industry agglomeration (2002). This makes the clusters very interesting for the small businesses, too. The small enterprises are flexible and able to respond much faster, the two critical traits for successful partnering with the big industry players (Markovski, 1997). Within a cluster the small businesses can transform their main disadvantage, the low volume of their output, into a source of competitive advantage.

As stressed in the Green Book (2009), the Porter's strong arguments in favor of clusters, considerably, influenced the policymakers, worldwide. Clusters are perceived as drivers of the prosperity in their native surroundings, helping entire regions to create unique profiles of specialized skills that allow constant upgrading of the role of its participants in the global economy. Governments at all level of power strive towards more proactive role in the implementation of their respective economic policies. The idea is to use their legitimate power and authority, not only to regulate, but also to foster the development of their economies. The design of more effective and efficient instruments of the economic policy is one of the critical prerequisite for this. Many policymakers and macro economists believe that this can be achieved, *inter alia*, with cluster focused rather than with "blanket" spatial distribution of the impact of the instruments of their industrial and development policies.

## **2. TYPES OF CLUSTERS**

Clusters differ, significantly, in relation to the actual form of the agglomeration. Far from being static, they have various levels of specialization and sophistication. The highly innovative clusters, like the Silicone Valley are rare. These, also known as Marshall's clusters, are narrowly specialized and include locally owned, small-and medium-size businesses concentrated in craft-based, design-intensive industries, high technology industries or advanced producer and financial services (Markusen, 1997). Sometimes the

agglomeration is result of abundant specific natural advantage. For instance, wine in France, olives in Spain, the Slovenian spa resorts on the rim of the Alps, and so on. Some studies suggest that the natural advantage accounts for about 20% of all observed agglomerations (Ellison and Glaeser, 1999). Other agglomerations target commodities and mass market. Their competitive advantages are created by practical means and vehicles like subcontracting networks, supply and sales pools, sharing some highly qualified business development services with strong industry focus. These clusters can be in form of Hub-and-spoke or focal firm clusters. These clusters are based on one, or few large businesses surrounded by input suppliers and service providers (Toulouse in France, Basque in Spain, or Torino in Italy inter alia). The small and medium sized companies around the focal company are much more heterogeneous and different then similar. They are result of the outsourcing of the operations of the focal company to the small businesses around it by sub-contracting arrangements. The focal company can also obtain market, serves as incubator for new ventures (like the textile cluster around Prato in Italy) or plays the role of an agent of change (Magnet Marelli or FIAT). Sometimes, the hub can be university, instead of a firm. Around the University of Cambridge in England a large network of high-tech companies is established. The satellite firms, often a spin off-s of the university heavily capitalize the vicinity of the knowledge and the expertise at the university (Wissema, 2008).

Italy is characterized with another form of the small business clusters. Usually, a group of small firms co-located in relatively delimited geographic area, will split the production process of the cluster product into distinct phases that are performed by various small firms. The Italian scholars put emphasis to the extensive sub-contracting between these vertically interrelated, small and medium companies on the value chain, as the main virtue of this form of commodities and mass market cluster (Boari, 2001). The small firms in this form of cluster can regroup fast, to address the changing requirements of the market. This results in significant flexibility and short response time, virtues that large firms are unable to provide. (Bianchi at al., 1997). Others, like the officials in the Italtrade, argue that in the case of the Italian clusters, the cooperation with the R&D institutions is not highly critical for their success; rather it is the sub-contracting practice based on a high confidence and trust between the members.

### **3. THE IMPORTANCE OF CLUSTERS FOR THE EU ACCESSION COUNTRIES FROM THE BALKANS**

The European Union Cluster Memorandum defines the innovativeness as the main driving force for growth and prosperity, indicating clusters as tools that catalyze these processes. Moreover, the European Competitive Council lists

clusters among the nine priority actions for strengthening the innovativeness. The prospects for growth are seen in the perfection rather than in the volume of the output, in the mobility of the high skilled workforce and in the interchange of the knowledge within areas of innovativeness and regional business networks that will allow intensive trans-border cooperation.

The cluster approach in the conceptualization and the implementation of the industrial and the regional development policy could prove convenient for the countries of the Western Balkans, too. Requirements for innovativeness and regional dimension of the interventions are present practically in all programs under the Instrument for Pre-Accession Assistance (IPA) and especially in the Competiveness and Innovation Program (CIP). These requirements are often very high for the small businesses. Having in mind that 98% of the companies in these countries are small; the concern that large portions of the European Union funding could remain unused seems quite realistic. In this situation, clusters could prove extremely instrumental for obtaining better access to these and to other similar funds. The companies from the Western Balkans will have much more chances to access the EU funding through national and regional clusters. However, two important questions should be addressed and resolved prior to this. The first question is how these spontaneous agglomerations to be traced effectively and efficiently, particularly in their nascent stages. The second question is could these early agglomerations be swiftly promoted through organized efforts from various stakeholders, particularly from the state and the regional governments.

#### **4. TRACING THE CLUSTERS**

The System of Input–Output Tables that can reveal the inter-industry relationships is considered as primary method of tracing (mapping) the clusters in the case of large industry. The Input Output Tables can identify groups of industries on a same value chain, from end-market sectors up to their primary, secondary and tertiary suppliers. The method could also be used, to some extend, to indicate the technological and other horizontal similarities among the industries as a proxy for the presumed inter-industry knowledge and skills proliferation. However, some inherent characteristics of the Input Output Tables effectively prevent their use for tracing the small business agglomerations. The pace of the change in the case of the small business is very fast, while the Input Output Tables usually lag several years. This is not so critical in the case of the larger industry players; their high capital requirements respectively slow the pace of the change with the volume of the funds invested. However, the



competitive outlook in the case of the small business segments of the industries/regions in focus would be meanwhile so changed that any conclusions with regard to the small business players would be extremely speculative. Moreover, the small businesses in their attempts to obtain the long-term viability often choose to register in one industry and to operate in quite different. This is specific for Macedonia, where the amount of the social contributions and taxation is predefined for each industry sector by the tax authorities.

Moreover, many scholars would argue that the trading patterns are not the necessarily the best and the only source of the otherwise, rather complicated and multidimensional, inter-industry relationships within a cluster (Renski at al., 2007). There are three (equal) sources of the external economies in a cluster: the supply chains, the labor pools and the knowledge spillovers (Krugman, 1991). Both the vertical (the supply chain) and the horizontal (the common resources) relationships should be equally considered during any attempt to assess the cluster strengths (Held, 1997). For example, in the USA, the Bureau of Labor Statistics publishes the National Occupational Industry Matrix that can be used to discover the clusters. The other very useful source of data in the case of the USA is the IMPLAN, or Employment by Industry Matrix. It yields various estimates of occupational distributions at the level of the states, counties and even larger municipal areas. Some empirical studies based on these and other sources of data turned significant differences in tracing and mapping the clusters based on Input Output patterns and that based on the occupational (labor) concentration (Renski at al., 2007).

The further course of action in the process of choosing the methodology for research of the small business regional agglomerations was to incline towards the scientists that advocate the statistically well-grounded spatial-pattern analysis, or analysis of the pace of the concentration of similar businesses as convenient proxy indicator for the potential for clustering, or even for the clusters itself. The logic of this approach is that it is easier to set links between closely collocated firms than between those across the regional or even national borders (Audretsch and Keilbach, 2005). The data requirements to assess the spatial density would include addresses of the firms and again, their respective statistical activity code. While this approach is also theoretically sound, the question is what would be the “normal” radius to monitor, or how large would be the monitored ecology for a cluster. The actual geography (valleys, surrounding mountains) significantly expands or borders the region in focus in any individual case. Finally, the problem with the discrepancy between the registered and the actual business activities is still there.

Within the research conducted for the Ministry of the Economy of the Republic of Macedonia, we surveyed the existing and potential concentrations

of small businesses in three regions, using carefully structured focused groups. We leveraged the presence and the capacity of the local business support and regional economic development agencies, together with the institutions of higher education. This infrastructure was established with prior programs of Government, European Agency for Reconstruction and various bilateral and multilateral donors support. Our approach is inline with many academics that study contemporary clusters: If the study region is well defined in advance, then it would be a quite opportune to focus on some “driver” industries and/ companies (Hill and Brennan, 1999).

The actual density of the businesses and the existence of the other factors of a cluster were verified during brainstorming session of the related focus group, comprised of all indentified stakeholders in the particular region. The assessment of the actual strength of the interrelationships with the specialized suppliers, important customers, providers of various business development services, banks and the research and development institutions was tested using the focus groups minutes and recordings and the interviews, questionnaires, performed afterwards. The focus groups were comprised of representatives of all active and potential actors and stakeholders, identified in the region. The focus groups and the interviews of the key stakeholders, give us insights into the perceived value of the various characteristics and functions of the particular agglomerations. The methodological foundation of this stage is also strong. In principle, the most flexible instruments to detect flow relationships are interviews and questionnaires within a narrowly targeted cluster case study. They allow tailoring the general research design perfectly to the individual objectives and providing valuable micro data (including interrelations within the cluster (Peneder, 1997)).

## **5. RESULTS OF THE SURVEY**

We managed, in an effective and efficient way, to indicate to several existing and potential small business clusters. We used different stakeholders to invite and host the focus groups in order to see are there any significant differences in the response from the invited. In the region of Ohrid, the survey turned the presence of critical mass of small business providers of alternative content of interest for tourists, like introduction to the traits of the local art craft: fishery, masonry, fresco, archeology, just to name a few. The survey in Ohrid showed various possibilities for direct engagement of the institutions of higher education in tourism and hospitality and for the Institute for preservation of the Ohrid Trout in the operations of this nascent cluster. The event was held at the institution of higher education. The event showed strong ties between the

tertiary (supporting) institutions (university, local business development agency and local municipality), but weaker links with the businesses.

In the region of Tetovo, the survey was hosted by the local business development agency with participation from all invited stakeholders, including fair number of businesses. The focus group indicated presence of strong potential for small business clusters in furniture, construction and, possibly, in the food processing. In the case of the furniture the model is value chain cluster with integrator firms located abroad (Croatia). In the case of construction cluster, the integrator firms are several. They provide various opportunities for various contracting. The presence of the small business development agency and the business centers of the two universities, seem very instrumental for the process, together with the availability of funds from the expatriates who invest in their native town. It will be interesting the emergence of the networking between these two clusters that according to the representatives in the focus groups is already visible.

In the Southeastern part of Macedonia, the focus group was held in Stip with stakeholders from all the towns in the region. The host was the Office for the regional development. The response rate, on the side of the businesses was very high. This focus group turned a strong potential for clustering in confectionery and in honey. In the case of the sweets, the model that emerges is actually big industry cluster. Moreover, the company that took the champion role at the event, later, organized and successfully set a clustering initiative that will inter alia, result in a strong local brand of cookie, will organize bulk procurement of basic ingredients, and so on. In the case of the honey cluster, it is populated, but in fact, it is a real micro cluster. However, the focus group did not manage to indicate the possible hub firm or any other type of cluster integrator. Probably the most effective would be some form of Cooperative, but it should be entirely left to the participants to decide.

Regarding the contacts with the research and development institutions, in all three surveyed regions, there were suitable institutions, in Ohrid, it is the University of Bitola, Faculty of Tourism, in the area of Tetovo, there were the Southeast European University and the State University of Tetovo and in the case of the Stip, it was the local University. However, the survey did not manage to indicate some formal agreements between the businesses and the research and knowledge institutions, aside from business counseling and intermittent executive training offered to the business community. On the other hand, this was expected, since the surveyed agglomerations proved to be much closer to the Italian models of small business clusters. They not necessarily use intensive linkages with the research and innovation providers. Moreover, scholars argue, that even the classical clusters, rely much more on implicit

knowledge: The economic agents' profits from these flows (of tacit knowledge), but in most cases are not entirely aware of their actual impact (Peneder, 1997).

## **CONCLUSIONS**

The general experience gained from the all three events is extremely in support of the use of focus group technique and other standard forms of surveying the stakeholders in processes of tracing the prospective or nascent clusters. This audience proved extremely informed and motivated to contribute. Consequently, the events were successful and helped the client, the Ministry of Economy, to plan its immediate as well as its future interventions. The fact that all the relevant stakeholders were in position to contribute, makes us confident to conclude that they will remain conducive and instrumental for the prospects of this identified clusters. Moreover, this encourages the expectations that they will even try to find their own interest to participate, directly or indirectly, into the operations of the new clusters. There are potential forms of cross-border cooperation that can be best managed using clusters. The requirements for innovativeness and regional dimensions of the IPA and CIP funding can be successfully addressed with clusters. Consequently, these agglomerations could prove extremely instrumental for obtaining better access to these funds, although there is a need for more formal linkages with the research and knowledge institutions. Since the structure of the small business support network is similar, we could also conclude that the experience gained with our research can be useful for the other countries in the Region. Moreover, since the contemporary competitive environment often dictates the value chains to include far players and having in mind that the relevant institutions of the European Union explicitly require the future business networks to include partners from the neighboring countries, the survey showed various possibilities for cross-border clustering. This can be achieved with or without partners from the developed countries. For example, in the case of the Ohrid and Struga, there are many possibilities for cooperation with the neighboring municipalities on the side of Albania and strong links with the specialized tourist agencies from Bulgaria and Albania. Then in the case of the construction cluster in the area of Tetovo, companies already have many projects in Albania, as well as in Kosovo.

We can conclude that the spontaneous agglomerations of small businesses can be mapped effectively and efficiently, even in their nascent stages, using carefully structured focus groups and a survey of key stakeholders. Regarding the second question, could these agglomerations be promoted through organized efforts from various stakeholders, particularly from the state and the regional government, the answer is again yes, although with some reserve in the case of research and universities.

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Original scientific paper**

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**THE IMPACT OF FOREIGN DIRECT INVESTMENT  
ON THE ECONOMIC GROWTH OF DEVELOPING  
COUNTRIES (2000-2010)**

**Abstract**

Bearing in mind the strategic influence of Foreign Direct Investments (FDIs) on technological development, knowledge transfer, economic growth and productivity enrichment of host economies, the study analyses the impact of inward FDIs on the economic growth in developing nations. The research methodology is based on the use of deductive logic and a time-series analysis of quantitative data from official sources. A sample of developing nations makes its scope, while the period covers the past decade i.e. 2000-2010.

The findings indicate that inward FDIs are attracted to developing nations with higher availability of educated labour, higher government spending and more efficient quality of governance. The level of education has not been recognised as a strong influential factor unlike the past studies, implying that education is losing its overall value and becoming a cost (not an investment) for developing nations. The findings and conclusions are especially valuable for international organisations and governments in the area of designing future policies and approaches for attracting and benefiting from the FDIs.

**Keywords:** Foreign Direct Investment, FDI, economic growth, developing countries

**JEL classification: O 10**

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## **Introduction**

The majority of developing countries reported a rapid increase in the inflow of foreign direct investment (FDI) during the late 1980s and the 1990s.<sup>1</sup> Along with the process of globalization and merging of national economies, these trends continued in the following decades with intensified cross-border investments triggering long debates among economists on the costs and benefits of FDI inflows.

Recent literature provides data on more than five original models that examine the impact on FDI on the Economic growth.<sup>2</sup> The models are mainly based on the theory provided by the endogenous and neoclassical models, with predominance of the endogenous models of economic growth.<sup>3</sup> In essence, there is a consensus among researchers that there is a positive correlation between FDI inflows and economic growth, provided that receiving countries have reached a minimum level of educational, technological and/or infrastructure development.<sup>4</sup> Unfortunately, there is still no universal agreement that there is a positive impact of FDIs on the economic growth. In most of these studies the causality FDI and Economic Growth, is examined in one way, i.e. the impact of FDIs on the Economic growth. The reversed impact, (of the Economic growth on the attraction of FDIs), has been researched with the studies on location determinants of FDIs where the impact of the economic growth is considered through the attractiveness of the market size.<sup>5</sup>

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<sup>1</sup> UNCTAD (2010b) "World Investment Report: Investing in a Low carbon Economy", in: UNCTAD, July, 2010, [http://www.unctad.org/en/docs/wir2010\\_en.pdf](http://www.unctad.org/en/docs/wir2010_en.pdf) (03.04.2011).

<sup>2</sup> De Mello, Luiz (1997) "Foreign direct investments in developing countries and growth: A selective survey", *Journal of Development Studies*, vol.34, no.2, pp.115-149;

Borensztein Eduardo, De Gregorio Jose and Lee Jong-Wha (1998) "How does foreign direct investment affect economic growth", *Journal of International Economics*, vol.45, pp.115-135;

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<sup>3</sup> Romer, Paul (1990) "Endogenous Technological Change", *Journal of Political Economy*, vol.98, no.5, pp.71-102;

Barro, Robert and Sala-i-Martin, Xavier (1995): *Economic growth*, New York: McGraw-Hill.

<sup>4</sup> Borensztein et al. 1998; Alfaro 2003; Balasubramanyam et al. 1999;

Campos, Nauro and Kinoshita, Yuko (2002) "Foreign direct investment as technology transferred: some panel evidence from the transition economies", *The Manchester School*, vol.3, no.6, pp.398-418.

<sup>5</sup> Capital Markets Consultative Group (CMCG) (2003), "Foreign Direct Investment in Emerging Market Countries", in IMF, September, 2003,



The study aims at providing updated information and analysis on the nexus FDI and Economic growth in the developing countries covering data from the past decade (2001-2010). There has not been a study on the topic in the period that takes in consideration the heterogeneity of the countries. Developing countries are chosen as a target population due to the fact that the impact of FDIs on the economic growth will be more obvious and easier to assess. In most of the cases it is assumed that the impact of FDIs in these countries is strong because the fresh capital required to support many of the needed reforms is low due to domestic distrust in bank savings and the low level of domestic investments. Moreover, the research of this specific group is of importance in light of the recent financial crisis and its impact on the global development, in particular, the impact on the investment plans of MNEs which make more than half of FDIs in the developing world.<sup>6</sup>

## **1. FOREIGN DIRECT INVESTMENT AND GDP NEXUS**

### **1.1. The models of economic growth**

Two basic definitions of the Economic growth subsist in the economic literature. According to the first definition, the economic growth is related to the growth of GDP and according to the second– it is related to the realised output per capita.<sup>7</sup> In spite of the definitions, in both of the cases the economic growth is related to the per capita output of the economy.

In an attempt to determine the factors of influence on the economic growth, various models were developed by economists in the past, covering two broad political-economic philosophies: the Classical (defending government non-intervention in the market mechanisms) and Merchantalism (defending government intervention at the market).<sup>8</sup> Both philosophies evolved in time, into the neoclassical and neomerchantalism respectively, reflecting the changes in the political, social and economic reality.<sup>9</sup>

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<http://www.imf.org/external/np/cmcg/2003/eng/091803.HTM> (20.07.2011); Billington, Nicholas (1999) "The location of foreign direct investment: an empirical analysis", *Applied Economics*, vol.31, no.1, pp.65-75;

<sup>6</sup> UNCTAD 2010b.

<sup>7</sup> Barro and Sala-i-Martin 1995.

<sup>8</sup> Miller David, Coleman Janet, Connolly William and Ryan Alan (1998): *The Blackwell encyclopaedia of political thought*, Oxford: B. Blackwell.

<sup>9</sup> Kegley, Charles and Wittkopf, Eugene (2004): *World politics – Trend and transformation*, Belmont, CA: Thomson/Wadsworth.

Neoclassical models dominated the 1970s and considered the accumulation of production factors such as labour and capital, as the dominant drivers of economic growth.<sup>10</sup> These models recognised the significance of the positive impact of technology on growth, but the cause of the influence was not considered. Therefore, these models failed to answer how a country can sustain a stable economic growth on the long run. These inadequacies have been a research topic of economists from the 1980s and onwards, triggering the emergence of new endogenous economy models.<sup>11</sup> The three main differences between the neoclassic and the new economy models include:

- factor savings and investments;
- factor technology and
- factor knowledge.

Opposite to Solow's model (which identified savings solely as determinants of the accumulation required for investments), in the new models (especially the first generation AK models savings are considered a crucial eternal force influencing long term growth, i.e. that only through new investments, population growth may promote economic growth.<sup>12</sup>

The models of Lucas and Romer did not follow the neoclassical approach towards technological change.<sup>13</sup> They argued in favour of the influence of new technological developments on the technical platforms, and further on the economic growth. New technical innovations have been recognised as areas which require investments in areas with higher returns than usual. The same

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<sup>10</sup> Solow, Robert (1956) "A contribution to the theory of economic growth", *Quarterly Journal of Economics*, vol. 70, no. 1, pp. 65-93;

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<sup>11</sup> Barro and Sala-i-Martin 1995;

Mankiw Gregory, Romer David and Weil David (1992) "A contribution to the empirics of economic growth", *Quarterly Journal of Economics*, vol. 107, no. 2, pp. 407-436;

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<sup>12</sup> Rebelo 1991; Romer 1989.

<sup>13</sup> Lucas, Robert (1993) "Making a Miracle", *Econometrica*, vol. 61, no. 2, pp. 251-272; Romer 1986.

explains why developed countries can sustain growth and why developing countries cannot.<sup>14</sup>

Considering that technology and competence were universally recognized as factors with positive influence on the economic growth, Barro and Sala-i-Martin, Mankiw et al. and Romer added knowledge to the standard inputs, as a crucial factor influencing productivity. i.e. they acknowledged growth as being conditioned by the national economy's level of human capital.<sup>15</sup>

In the process, Foreign direct investments (FDIs), are recognized as a particularly significant vehicle of international technology transfer.<sup>16</sup> They bring capital, technology transfer and transfer of skills and knowledge to the host economy, hence affecting all three factors of the endogenous growth models. These transfers are more important for the host country development, than the capital addition, since exports and employment are positively affected and the level of human capital is increased. This further serves as a platform for attracting high value added foreign investments in the country.<sup>17</sup>

## **1.2. Foreign Direct Investment as a factor for increasing economic growth**

**Foreign Direct Investment** is defined as a cross-border investment in which a resident in one economy (the direct investor) acquires a lasting interest in an enterprise in another (the direct investment enterprise). By convention, a direct investment is established when the direct investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad. FDIs involve the creation of a new establishment or investment (Greenfield

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<sup>14</sup> Romer 1986.

<sup>15</sup> Barro and Sala-i-Martin 1995; Mankiw et al. 1992; Romer 1986;

Van den Berg, Hendrik (2001): *Economic Growth and Development*, Boston Mass.: McGraw-Hill.

<sup>16</sup> Ferreira, Luisa and Vanhoudt, Patrick (2004) "Catching the Celtic tiger by its tail", *European Journal Of Education*, vol.39, no.2, pp. 209-236;

Balasubramanyam et al. 1999; Borensztein et al. 1998.

<sup>17</sup> Miyamoto, Koji (2003) "Human capital formation and foreign direct investment in developing countries" in: Organisation for Economic Co-operation and Development (OECD): Technical Paper No. 211, July, 2003, <http://www.oecd.org/dataoecd/45/25/5888700.pdf> (20.07.2011);

Noorbakhsh Farhad, Paloni Alberto and Youssef Ali (2001) "Human capital and FDI to developing countries: New empirical evidence" *World Development*, vol.29, no.9, pp.1593-1610.

investments), joint ventures, or the acquisition of an existing enterprise abroad (cross-border mergers and acquisitions)<sup>18</sup>.

FDIs is treated as one of the most significant generators of economic growth in the endogenous models, due to its impact on host economy level of investments, technology transfer and human capital formation – elements particularly significant for developing countries.

The new endogenous models of economic growth provide the theoretical model, but until today, there is uncertain empirical research on the positive influence of FDIs.<sup>19</sup> Borensztein, Mankiw and Easterly developed various models for assessing the impact on several factors on GDP growth, among which the FDI influence proved to be the key factor.<sup>20</sup> However, this influence was never statistically independent from the other control factors, as were the *human capital*<sup>21</sup>, *developed financial markets*<sup>22</sup>, *openness of the economy*<sup>23</sup>, *macroeconomic stability*<sup>24</sup>, *overall investment*<sup>25</sup>, and the *quality of governance*<sup>26</sup>.

Findings of the positive influence of FDI on economic growth should be considered carefully, since the relationship between FDI and growth is not homogenous, but rather heterogeneous across countries.<sup>27</sup> For example, from 1990-till 2000, FDI increased in Central Europe, while GDP dropped, or to add more to this controversy, Zoltan outlined that “while the stock of FDI in proportion to GDP in 2000 was 43.2% in Hungary, 40.4% in the Czech Republic, 20.1% in Poland and 19.3% in Slovakia, it was only 16.1% in Slovenia which was ECE’s most developed country, but received the smallest

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<sup>18</sup> Organisation for Economic Co-operation and Development (OECD), (2001) Glossary of Statistical Terms: Foreign Direct Investment, November, 2001, <http://stats.oecd.org/glossary/detail.asp?ID=1028> (20.07.2011).

<sup>19</sup> Lucas 1993; Romer 1986.

<sup>20</sup> Borensztein et al. 1998; Mankiw et al. 1992;

Easterly, William (2001): The elusive quest for growth, Cambridge Massachusetts: MIT Press.

<sup>21</sup> Borensztein et al. 1998; De Mello 1997; Balasubramanyam et al. 1999.

<sup>22</sup> Alfaro et al. 2004; Borensztein et al. 1998.

<sup>23</sup> Balasubramanyam et al. 1999; Borensztein et al. 1998.

<sup>24</sup> Borensztein et al. 1998.

<sup>25</sup> Alfaro, Laura (2003) “Foreign Direct Investment and Growth: Does the sector matter?”, Harvard Business School;

Borensztein et al. 1998.

<sup>26</sup> Borensztein et al. 1998; Alfaro 2003.

<sup>27</sup> Nair-Reichert, Usha and Weinhold, Diana (2001) “Causality tests for cross-country panels: a new look at FDI and economic growth in developing countries”, Oxford Bulletin of Economics and Statistics, vol.63, no.2, pp.153-170;

amount of foreign investments”.<sup>28</sup> Saltz even proved that FDIs negatively influence growth in the countries of the third world.<sup>29</sup>

All this leads to the conclusion that FDI-growth nexus is not by definition positive as the theoretical frame of the endogenous models predicts, but largely depends **on the conditions in the host economy that attract investments and country’s ability to regulate foreign investment**. Therefore a combination of a homogenous and heterogeneous approach might provide more reliable data.

### 1.3. Foreign Direct Investment and its location determinants

Dunning’s work and its eclectic theory of internationalisation suggests that firms decide to internationalise based on the assessment of their ability to compete at international markets through ownership, location, and internalisation advantages.<sup>30</sup> The eclectic approach is the most comprehensive approach explaining the internationalisation of firms<sup>31</sup>, and although primarily designed for the manufacturing sector, its validity has been proved for the service sector as well.<sup>32</sup> From the first empirical studies<sup>33</sup> until today, the empirical models have provided evidence for the following factors impacting FDI location: *Market size*<sup>34</sup>, *Economic stability and Growth*<sup>35</sup>, *Available human*

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<sup>28</sup> Gardiner, Rosalie (2000) “Foreign direct investment: A lead driver for sustainable development?”, in UNED International Team, Economic briefing series No.1 Full-text, November, 2000, <http://www.eldis.org/static/DOC10390.htm> (20.07.2011);

Zoltan, Adam (2002) “Fine-tuning foreign investment: Differentiating FDI and portfolio investment in post-communist East Central Europe”, Proceedings from Second EPIC Workshop in Florence. EPIC.

<sup>29</sup> Saltz, Ira (1992) “The negative correlation between foreign direct investment and economic growth in the third world: Theory and evidence”, *Rivista Internazionale di Scienze Economiche e Commerciali*, vol.39, no.7, pp.617-632.

<sup>30</sup> Dunning, Jhon (2001): The key literature on IB activities 1960-2000. In A. C. Rugman, ed. The Oxford Handbook of International Business 1ed. (36-68), New York: Oxford University Press;

Hollensen, Svend (2007): *Global marketing: a decision-oriented approach*. London: Pearson Education Publishing.

<sup>31</sup> Cumberland, Flemming (2006) “Theory Development within International Market Entry Mode - An Assessment”, *The Marketing Review*, vol.6, no.4, pp.349-373.

<sup>32</sup> Cole Cassandra, Lee Ryan and McCullough Kathleen (2007) “A Test of the Eclectic Paradigm: Evidence From the U.S. Reinsurance Market”, *Journal of Risk & Insurance*, vol.74, no.2, pp.493-522.

<sup>33</sup> Agarwal, Jamuna (1980) “Determinants of foreign direct investment: A survey”, *Review of World Economics*, vol.116, no.4, pp.739-773;

Schneider, Friedrich and Frey, Bruno (1985) “Economic and political determinants of foreign direct investment”, *World Development*, vol.13, no.2, pp.161-174.

<sup>34</sup> Sahoo, Pravakar (2006): *Foreign Direct Investment in South Asia: Policy, Trends, Impact and Determinants*, ADB Institute Discussion paper No. 56, Tokyo: Asian Development Bank Institute.

<sup>35</sup> Duran 1999; Sahoo 2006.

*capital*<sup>36</sup>, *Trade openness*<sup>37</sup>, *Currency value*<sup>38</sup>, *Infrastructure*<sup>39</sup>, *Labour cost*<sup>40</sup>, *Gross capital formation and Quality of governance*<sup>41</sup>.

## 2. RESEARCH METHOD

The study is formal and deductive, i.e. it builds on previous theory in the area. It is based on descriptive and inferential statistical analysis based on quantitative data collected from secondary sources, and a time-series analysis on a sample of developing nations. Data is gathered from various academic sources (First Search, Emerald, EBSCO) and various cross-country and policy reports prepared by OECD, World Bank, UNCTAD, and IFC. A positivism philosophy is chosen as an applied research philosophy reflected in the deductive study and the scientific approach.

### 2.1. Research Model

Many researchers have investigated the impact of inward FDIs on economic growth and vice versa – the impact of economic growth on FDIs' decision regarding the choice of location. Both streams of research are based on different but not necessarily confronting assumptions. The positive influence of FDIs on the economic growth is based on the assumption of the endogenous model of the economic growth.<sup>42</sup> In the process the positive influence of FDIs on the economic growth and most of the empirical models for assessing the impact are based on the endogenous model<sup>43</sup>:

$$GROWTH_j = \beta_0 + \beta_1 INITIALGDP + \beta_2 FDI + \beta_3 CONTROLVARIABLES + e$$

<sup>36</sup> Lipsey, Robert (2000): Interpreting developed countries' foreign direct investment, Cambridge MA: National Bureau of Economic Research (NBER Working);

Campos and Kinoshita 2002;; Sahoo 2006.

<sup>37</sup> Duran 1999.

<sup>38</sup> Levy-Yeyati, Eduardo and Sturzenegger, Federico (2003) "To Float or to Trail: Evidence on the Impact of Exchange Rate Regimes", American Economic Review, vol.93, no.4, pp.1173-1193.

<sup>39</sup> Loree, David and Guisinger, Stephen (1995) "Policy and non policy determinants of U.S. equity foreign direct investment", Journal of International Business Studies, vol.26, no.2, pp.281-299.

<sup>40</sup> Agarwal 1980; Schneider and Fray 1985; Lucas 1993.

<sup>41</sup> Loree and Guisinger 1995;

Kaufmann Daniel, Kraay Aart and Zoido-Lobaton Pablo (2000) "Governance Matters: From Measurement to Action" Finance and Development, vol.37, no.2, pp.10-13.

<sup>42</sup> Romer 1990; Barro and Sala-i-Martin 1995.

<sup>43</sup> Barro and Sala-i-Martin 1995.

In the model, the economic growth is measured with GDP per capita growth rate, while FDIs is measured as a percent of GDP. The Initial GDP per capita variable is included in the model as it provides a control over the convergence.<sup>44</sup> The control variables are schooling, macroeconomic stability, quality of governance and similar. Their purpose is to provide information on the different conditions of the different countries.

### 3.2. Sample

All countries satisfying the criteria for a developing country make up the target population<sup>45</sup>. Countries from all regions, and countries from all sub segments of the developing world in accordance to World Bank Classifications, are included in the sample. Furthermore, the choice was made on countries for which there is enough available data coming from at least two respectful sources – the World Bank database and the UNCTAD database.

**Table 1. Developing countries – sample**

Europe	Africa	North & Central America	South America	Asia	Middle East	Additional
Armenia	Egypt	Dominican Republic	Argentina	India	Iran	China, (excluding Hong Kong)
Azerbaijan	Libya	Grenada	Brazil	Indonesia	Jordan	
Croatia	Morocco	Guatemala	Colombia	Malaysia	Syria	
Serbia & Montenegro	Tunisia	Mexico	Paraguay	Thailand		
Turkey			Peru			
Macedonia			Uruguay			
<i>Source: World Bank Database (2011)<sup>46</sup>; UNCTAD database (2011)<sup>47</sup></i>						

<sup>44</sup> ibid.

<sup>45</sup> World Bank, 2012

<sup>46</sup> World Bank database (2011), <http://data.worldbank.org/> ( 20.07.2011).

### 3.3. Variables and data sources

All variables, factors, sources of data and measurement indicators are presented in Table 2. All used measures have been suggested, used and tested in previous research and are found to be a reliable measure for the required variables in the model.

**Table 2. Variables, Indicators, Data**

Factor	Variable	Measure	Developed/ Used by	Source
<b>Economic Growth</b>	Growth	GDP per capita growth rate (%); Initial GDP per capita in \$	Barro and Sala-i-Martin 1995;	World Bank Database of Indicators (2011) UNCTAD Statistics (2011); National Statistical Offices from the Relevant countries
<b>FDI</b>	FDI	FDI as a percent of GDP (%)	Borensztein et al. (1998) Alfaro (2003, 2009)	World Bank Database of Indicators (2011) UNCTAD Statistics (2011); National Statistical Offices from the Relevant countries
<b>Human capital</b>	Schooling	Average years of secondary school attainment	Barro and Sala-i-Martin (1995)	World Bank Database of Indicators (2011) UNCTAD Statistics (2011); National Statistical Offices from the Relevant countries
<b>Macroeconomic stability</b>	Inflation	Percentage changes in GDP deflator (%)	Borensztein et al. (1998) Alfaro (2004, 2009)	World Bank Database of Indicators (2011) UNCTAD Statistics (2011); National Statistical Offices

<sup>47</sup> UNCTAD STAT (2011),  
<http://unctadstat.unctad.org/TableViewer/tableView.aspx?ReportId=89> (20.07.2011).



				from the Relevant countries
<b>Developed financial markets</b>	Private credit	Private credit as a percent of GDP (%)	Borensztein et al. (1998) Alfaro (2003, 2009)	World Bank Database of Indicators (2011)
<b>Overall Investment</b>	Investment	Investment (domestic and foreign) as a % of GDP	Borensztein et al. (1998) Alfaro (2004)	World Bank Database of Indicators (2011) UNCTAD Statistics (2011); National Statistical Offices from the Relevant countries
<b>Quality of governance</b>	Governance	An annual average of 6 World Bank Governance indicators.	Balasubramanyam et.al.,1999, Borensztein et al. (1998), Kumar (2000)	World Bank Database of Indicators (2011) UNCTAD Statistics (2011); National Statistical Offices from the Relevant countries
<i>Source: World Bank Database (2011)<sup>48</sup>; UNCTAD STATS (2011)<sup>49</sup></i>				

### 3. RESEARCH RESULTS AND INTERPRETATION

The analysis begins with the use of the endogenous model and the introduction of the INITIAL GDP variable to the *FDI/GDP rate – Regression 1* column in Table 3. Although the model indicates a significance of the impact of FDI/GDP ratio over GDP per capita as the FDI/GDP p value is less than 0.05, the relatively low value of  $R^2$  (69%) is a moderate predictor of the impact. Therefore, one can conclude that the impact of FDI on GDP growth when there is a control for the initial income is significant but moderate.

The further analysis according to the model continues with the test of the impact of FDIs on the GDP by the introduction of each of the control variables (regressions 2 until regression 7). In the case of the modified regression 8, the

<sup>48</sup> World Bank Database 2011.

<sup>49</sup> UNCTAD STATS 2011.

sample is reduced with 3 countries for which there was not available data on 'government spending' from reliable sources. Regression 9 includes the impact of all control variables and provides a robust check of the model.

In all of the regressions, the impact of FDIs on the GDP is significant as the p-value is less than the 0.05. However, due to the lower values of Multiple R, the probability with which the model can be used to predict future pattern is relatively weak. Only in the Regression 8, where the government spending is included as a control variable, the model provides a higher value of multiple R. Therefore, **FDIs in combination with higher government spending significantly increase the economic growth of the host nation.**

The robust regression 9, i.e. the robust check of the model, provides significant values for Multiple R.

As the availability of skilled labour was identified as a major factor for attracting FDIs, a new variable is included in the model: *FDI\*Schooling* – Regression 1.1 – Table 4, which reflects the model of Borensztein and significantly impacts GDP as well.<sup>50</sup> The new variable in Regression 1 along with the Initial GDP and Schooling variable provides a more reliable prediction of the model, i.e. 78% probability (multiple R).

The strengthened validity of the model reflects the findings from the 80s and 90s, which claim that FDIs positively affect the economic growth of the host economy, provided that there is available educated labour in the country.<sup>51</sup> The fact that the findings of this study are less significant compared to these findings is in line with the later studies on Eastern European countries where the level of education was found to losses its value once the threshold is achieved.<sup>52</sup> Therefore, the findings emphasize the advanced level of human capital present in the developing nations.<sup>53</sup>

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<sup>50</sup> Borensztein et al. 1998.

<sup>51</sup> *ibid*

<sup>52</sup> *ibid*; Campos and Kinoshita 2003.

<sup>53</sup> *ibid*.

**Table 3. First Model of Regressions**

	Regression 1	Regression 2	Regression 3	Regression 4	Regression 5	Regression 6	Regression 7	Regression 8	Robust Regression 9
<b>Initial GDP</b>	0.03130** (-2,2870)	0.040362 (-2,1726)	0.035323093 (-2,2362)	0.02901643 (-2,3288)	0.040205438 (-2,1744)	0.034832235 (-2,2429)	0.078855673 (-1,8390)	0.012111878 (-2,7587)	0.050296397 (-2,1416)
<b>Schooling</b>		0.8791* (-0,1537)*							0.87406391 (-0,1614)
<b>Inflation</b>			0.818349624 (0,2323)						0.474908316 (0,7342)
<b>Government spending (% of GDP)</b>				0.144117165 (-1,5121)					0.974985376 (-0,03192)
<b>Openness of the economy</b>					0.415106346 (-0,8299)				0.597475205 (-0,5403)
<b>Private credit</b>						0.865278208 (-0,1715)			0.855764708 (-0,18515)
<b>Quality of governance</b>							0.1535 (-1,4757)		0.899690347 (0,1283)
<b>Investment as a% of GDP</b>								0.000624398 (4,05102)	0.00752932 (3,1198)
<b>FDI (%) of GDP</b>	0.00067085 (3,9042)	0.001120017 (3,7216)	0.00085082 (3,8330)	0.000278018 (4,2831)	0.000626257 (3,9567)	0.00088652 (3,8164)	0.000347275 (4,1938)	0.000596112 (4,07084)	0.00611539 (3,2244)
<b>Multiple R</b>	0.6915	0.6915	0.6920	0.7245	0.7020	0.6916	0.7231	0.860	0.878

Source: Multivariate regression on data collected from World Bank Database (economic growth - dependent variable, the rest are independent variable)

**NOTES** \*The first value provided in the table cells of the variables is the p-value. The second value, bellow the p-value is the t-value. Both values are for a two-tail test

\*\* Significant are those values where the value of p is less than 0.05.

As most of the previous models investigate the impact of the macroeconomic stability through the use of the inflation variable, for assessing the impact of inflation on FDIs and on the economic growth, a new variable has been introduced: *FDI\*Inflation – Regression 2.1*. It does not improve the significance of the model and the impact of the inflation, but discovers that despite the relatively volatile decade the sampled developing countries have achieved a significant level of macroeconomic stability.

To investigate the impact of FDIs and *government spending* on the attraction of FDIs and the economic growth of the host nation, a new variable is included - *FDI\*Gdsending - Regression 3.1*. The results point that the impact of the government spending improves the validity of the model for 10 points, indicating that FDIs are attracted to countries with higher levels of government spending.

The *openness of the economy* has a surprisingly low effect on inward FDIs and on the economic growth of the host nation. The inclusion of a new variable: *FDI\*openness - Regression 4.1*. provides a low improvement of the model. These findings contradict the findings from the last decade of the past century where the importance of the openness of the economy for the FDIs and the economic growth was significant<sup>54, 65</sup>. The intensified process of liberalisation of the global economy in the past decade, and the fact that almost all countries in the world today are liberalised may be an explanation for the low significance.

Finally, the model includes a new variable: *FDI\*Quality of governance – Regression 5.1*, which significantly impacts the economic growth and attracts inward FDIs, since it is very significant for the decision on the choice of location. The results of the empirical tests of the model are provided in Tables 3 and 4.

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<sup>54</sup> Basu Parantap, Chakraborty Chandana and Reagle Derrick (2003) “Liberalization, FDI and growth in developing countries: a panel cointegration approach”, *Economic Inquiry*, vol.41, no.3, pp.510-516.

**Table 4. Second Model of Regressions with additional control variables**

	Regression 1.1	Regression 2.1	Regression 3.1	Regression 4.1	Regression 5.1.	Regression 7.1
<b>Initial GDP</b>	0.0068** (-2,9894)	0.0378 (-2,2104)	0.0344 (-2,2549)	0.0261 (-2,3857)	0.0536 (-2.0334)'	0.2449 (-1,2071)
<b>Schooling</b>	0.0574* (2,0053)					0.5354 (0,6334)
<b>FDI*Schooling</b>	0.0231 (-2,4414)					
<b>Inflation</b>		0.6980 (0,3931)				0.7691 (0,2985)
<b>FDI*Inflation</b>		0.7491 (-0,3238)				
<b>Government spending (% of GDP)</b>			0.0863 (-0.17987)		0.1157 (1.6378)'	0.3709 (0,9205)
<b>FDI*Gdspending</b>			0.0048 (-3,1343)		-3.1869 (0.0042)'	
<b>Openness of the economy</b>				0.4803 (0,71803)		0.2255 (-1,2605)
<b>Private credit</b>						0.1083 (-1.7009)
<b>Quality of governance</b>						0.1064 (-1,7111)
<b>FDI (%) of GDP</b>	0.0006 (3,9766)	0.0692 (-1.9101)	0.0001 (-4.7782)	0.0514 (-2.0604)	0.4448 (0.7781)'	0.0002 (-4.8864)
<b>FDI*Openness</b>				0.2503 (-1,1807)		
<b>FDI*Schooling</b>						0.7133 (-0,3739)
<b>FDI*Gdspending</b>						0.1180 (-1,6522)
<b>Multiple R</b>	0.7678	0.6938	0.8195	0.7233	0.8207	0.8686

Source: Multivariate regression on data collected from World Bank Database (economic growth - dependent variable, the rest are independent variable)

**NOTES** \*The first value provided in the table cells of the variables is the p-value. The second value, below the p-value is the t-value. Both values are for a two-tail test.

\*\* Significant are those values where the value of p is less than 0.05.

## CONCLUSION

The applied empirical model in the study provides strong support for the impact of inward FDI on the economic growth of developing nations in the past decade. Findings indicate that inward FDIs were attracted to the developing nations with higher availability of *educated labour*, *higher government spending* and more *efficient quality of governance*. In the process, the *level of education* although significant, was not recognised as a factor with strong effect, implying that the level of education (secondary education) is losing its investments value and is becoming a cost for the developing nations. In present time the economists regard only the primary education as a cost, while the secondary is seen as an investment. These findings should be built-in in further government educational strategies and policies in developing countries where secondary education should be obligatory.

The largest surprise is the low impact of the *openness of the economy*, previously regarded as a factor with strong impact on FDIs on the economic growth. The reasons may be identified in the high liberalization of developing countries and the pro-active policies for strengthening the openness of economies<sup>55, 66</sup>.

Concerning the question of the *causality* of FDI and GDP, the findings do not provide conclusive evidence of the existence of a virtues circle, hence the causality is concluded to be more of a one-way causality, while the vice versa effect is low. The findings, however, do point to an existence of a connection between FDI and economic growth which is strengthened when other factors are included in the analysis; a very significant matter for the economy of the developing nations.

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**Original scientific paper**

**Shiret ELEZI \***

**CURRENT STATE OF LOCAL FINANCES IN  
THE REPUBLIC OF MACEDONIA**

**Abstract**

Decentralization in Macedonia was conceived in two phases, (July 2005 and July 2007), where the local Government got asymmetric allocation of fiscal powers. During the first phase, all local governments were assigned the responsibility to deliver only a few mainly communal local government functions. After fulfillment of specific conditions and approval by the central government, the municipalities in Macedonia were allowed to have new functional responsibilities. This overview analyzes key indicators of local finance in 2010 and 2011: the revenues and expenditures in Macedonia, the evolution of local government revenues and expenditures in Macedonia, the comparing with the GDP, public revenues, and in general the main problems of the intergovernmental finance system.

**Key words:** local government, budget, central government, revenues, expenditures, VAT, PIT, GDP, share tax, earmarked grants, regional development

**JEL classifications:** H7, H72, H76, H77

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## **Introduction**

When the decentralization reform process in Macedonia commenced in 2005, the capacities of local government level were not assumed to be adequate for all local governments to deliver a broad range of public services. As a result, the decentralization process was conceived of in two different phases, allowing for an asymmetric allocation of fiscal powers. At first local governments were assigned the responsibility to deliver only a few local government functions. After fulfillment of specific conditions and approval by the central government, in Macedonia were allows taking on other functional responsibilities.

In 2011, 78 of Macedonia's 85 jurisdictions including the City of Skopje had entered the second phase of decentralization in fact (83 municipalities together with City of Skopje in 2012 entered the second phase) and assumed responsibility for major special; sector functions, education (primary and secondary education), social welfare (kindergartens and homes for the elderly) and culture (libraries, museums, theatres), fire units.

This assumption of responsibilities' to municipalities began to receive grants designed to help them to pay for the costs of managing and financing these institutions. These grants have led to a very significant increase in local government revenues as share of GDP and total public expenditures and revenues.

In 2005, when the decentralization process began the local government revenues as share of GDP have risen from 1,89 % to, 5,66% in 2010 and 5,8 % for 2011. But even there are increased local revenues, in fact 2,8% from GDP are account for paying teachers wages, while the increase in local resources is considerable in nominal terms, Macedonian municipalities continue to be underfunded when compared to municipalities in countries where similar functions have been decentralized to local governments where countries typically spend 3 -5% of GDP on pre-tertiary education. If we use this same sorts of international corporations, one would expect that Macedonian local governments would have –given the functions that have been assigned to them – revenues equal to between 8-9% of GDP, and not 5%. Macedonian's evolving system of intergovernmental fiscal relations, the primary objective study is to monitor the overall development of Macedonians decentralization efforts and to highlight the main problems of the country's intergovernmental finance system.

This puts Macedonia on the low side of European norms, were most countries spend between 3-5% of GDP on education, all other local expenditure responsibilities' are funded less then 2,6% of GDP and less then 8% of total public expenditures. Unfortunately, these mean that local government revenues in Macedonia remain very low. If we compare with some countries in the region that are responsible for teacher wages, Macedonian municipalities revenues are

significantly lower as a percent of GDP than those of other countries in which local governments are responsible for teachers pay. So, if we remove education grants from the Macedonian figures, local government revenues as a percentage of GDP would be lower than 2,6 % of GDP than in all the countries in which local governments are not responsible for teachers pay.

For example Hungary's municipalities get 12,3 % of GDP (2009), Poland municipalities get 14,7% of GDP (2006), Bulgaria municipalities get 8,2% of GDP (2009), Macedonia 5,4 %of GDP in 2010.

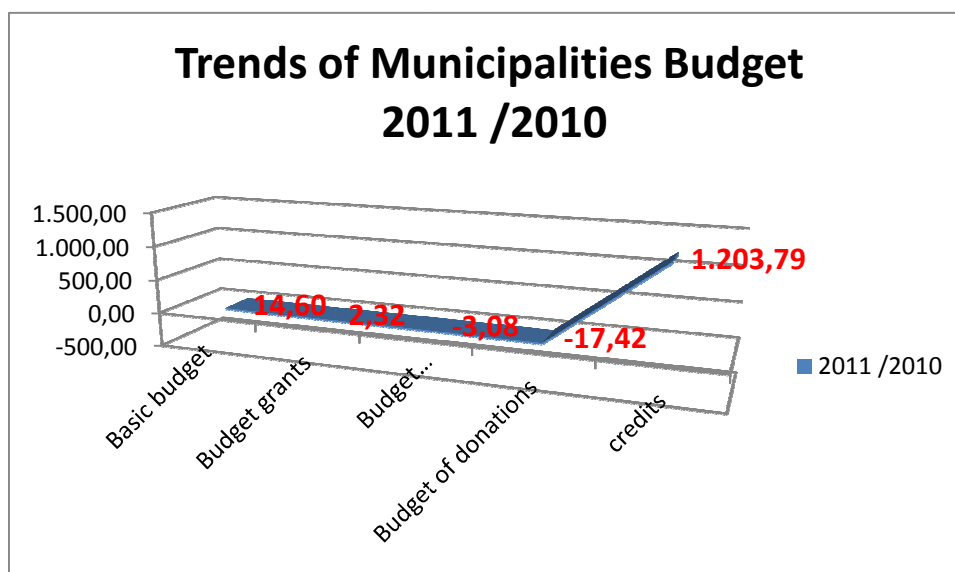
Countries in which Local Governments do not pay teachers wages example, Serbian's municipalities get 5,1 % of GDP (2009), Turkey's municipalities get 5,4% of GDP (2009), Croatian's municipalities get 5,8% of GDP (2006).

Even if local governments revenues rise to 7% of GDP the next 2-5 years, the Macedonian municipalities would still be low in comparing to the other countries in the region, given the fact that unlike most Macedonians municipalities pay teachers wages. This convinced that they efforts in this direction must be made.

## **1. LOCAL GOVERNMENT REVENUES 2010 and 2011**

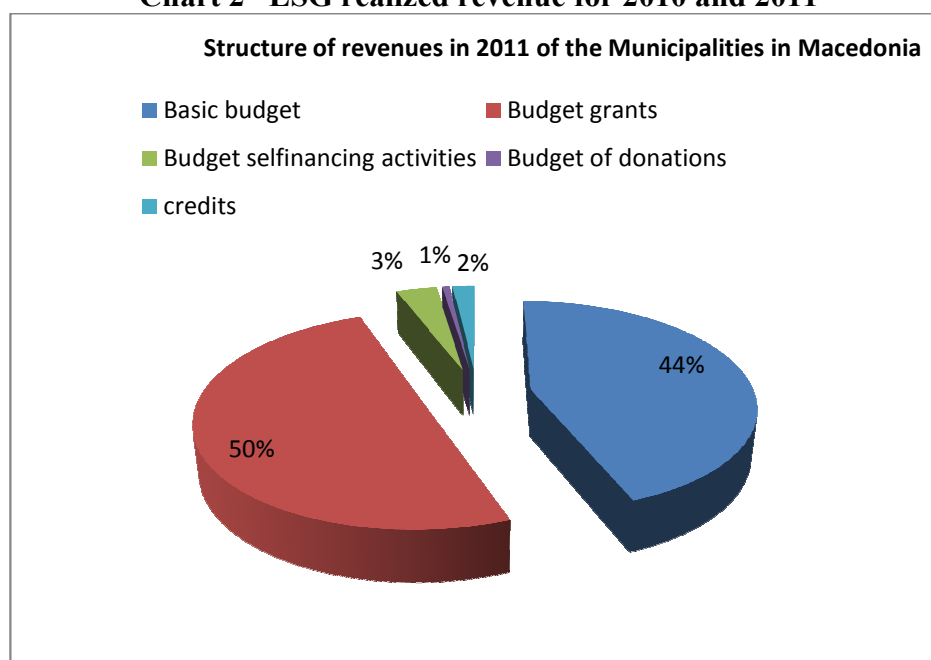
According to data in total revenue for municipalities in 2011 can be found the increase of 9.35% compared with 2010. The highest growth is in funding loans for more than 12 times in 2011 compared with 2010. The base budget, the municipalities are financed from, own revenues as a source of funding is a revenue growth of 14.60%. This is due to improved collection of own revenues and higher amounts of the ceded revenue from concessions of mineral raw materials and sales of construction land. In 2011 revenues by donations was 17.42% and from self-financing activities 3.08%. It should be noted that dependence on central government is reduced below 50%, compared with 2010 when it was nearly 53% as measured by the share of subsidies in total expenditures of municipalities and at the same time we increase the share of financing costs from their income.

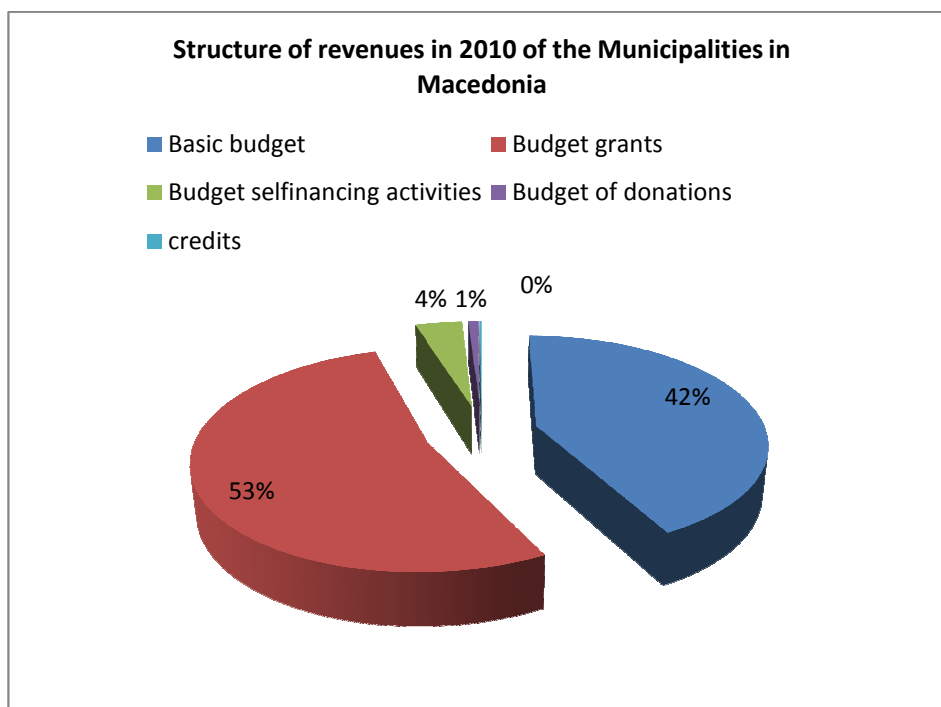
**Chart 1. Trends of Municipalities Budget 2010-2011**



Source: Annual Final Accounts of Municipalities in Macedonia, own calculations

**Chart 2 LSG realized revenue for 2010 and 2011**





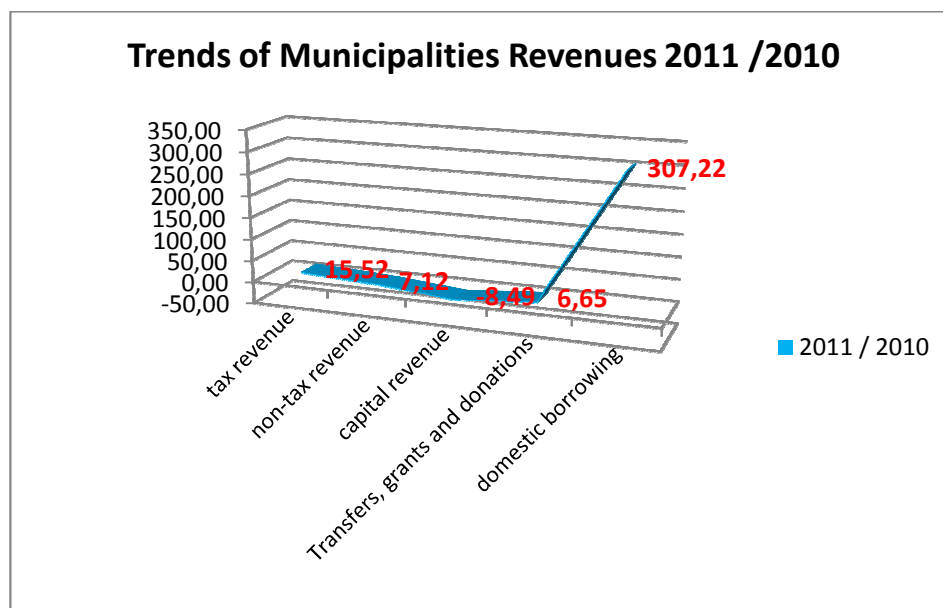
Source: Annual Final Accounts of Municipalities in Macedonia, own calculations

From the analysis of revenues by type, we can find growing tax revenues by nearly 16% in 2011 compared with 2010. Capital revenues decline with mild dynamics due to the higher amount in the previous year.

Worth noticing is the increased interest in borrowing in financial institutions as a source of funding for capital investments which are used, and the possibility of borrowing in the short or long term from the Central Budget of the Republic of Macedonia overcoming the situation of lack of funds or time discrepancy of revenues and other receipts, expenditure and other outflows (lending in 2011 amounted to 1.82% of total revenues).



**Chart 3 Trends of Municipalities Revenues 2010-2011**



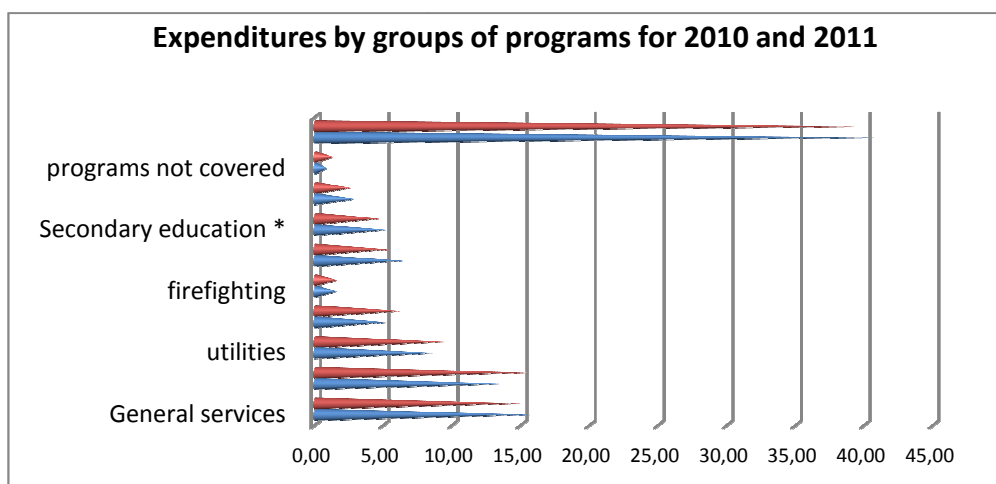
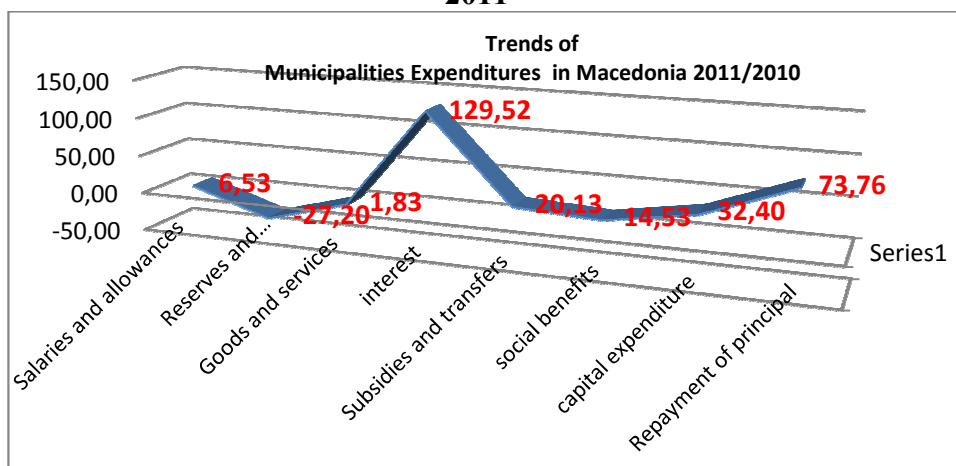
Source: Annual Final Accounts of Municipalities in Macedonia, own calculations

Dependence on transfers from central government and donations amounting to about 61% in 2011 recorded a slight decrease compared with 2010 when their share was almost 63%.

## 2. EXPENDITURES OF MUNICIPALITIES IN 2010 and 2011

Total expenditures in 2011 increased about 11% in terms of achievements in 2010. The highest increase capital expenditures have increased over 30%, subsidies and transfers about 20%. The increase in repayment of principal and interest on taken loans confirms the tendency of attractiveness of the process of borrowing to finance capital projects. Other expenses are realized according to anti-crisis measures and reduction of unproductive expenditure.

Spreadsheet. Expenditures of municipalities for 2010 and 2011

**Chart 4. Trends of Municipalities expenditures in Macedonia 2010-2011**

Source: Annual Final Accounts of Municipalities in Macedonia, own calculations

If we compare the expenditure of 2011 in respect of 2010, an analysis of the share of expenditures by type can be concluded an increase of 6% of wages and allowances due to entry of new municipalities in the second phase of fiscal decentralization (salaries and allowances of local public institutions of education, social welfare and culture) while the expenditures for goods and services follow the dynamics of over 20%, because they involve the expenditure of local public institutions. To mark the share of capital expenditures by over 24% of total expenditure improves infrastructure and encourages overall

economic development of the municipality, and thus the quality of local services. Moreover this positive trend is reflected in municipalities and by reducing the share of wages in 2011 (from 50% to 48%) compared to 2010 while increasing the share of capital expenditures (from 20.65% to almost 25%).

During the 2011, the shown growth of expenditures for interest and repayment of principal is due to an increase in borrowing in 2011 compared to the previous years.

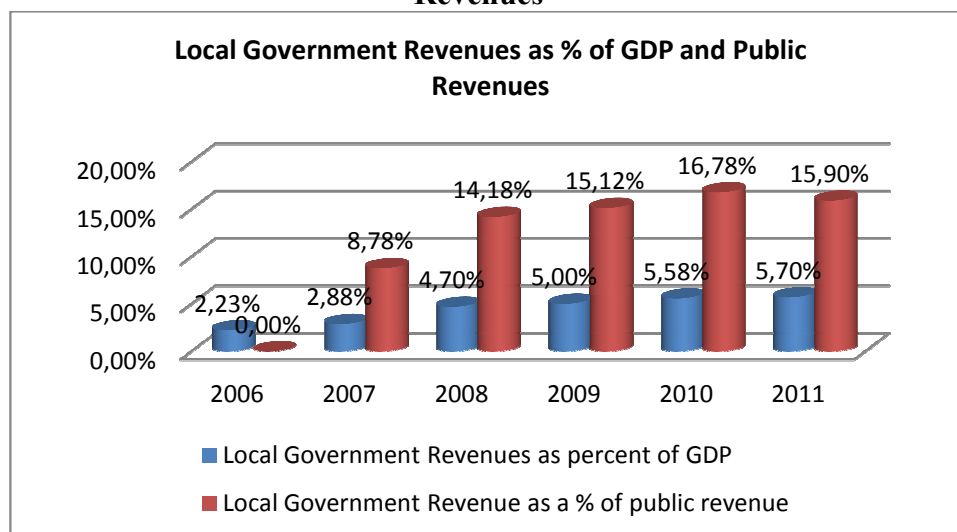
It is clearly shown that credit is used for investment in economic development, education and public utilities as from medium to long term it could improve the business environment, competitiveness of LSU and future investment through the multiplier effect and improve quality of life of citizens.

### **3. LOCAL GOVERNMENT REVENUES AS A SHARE OF GDP AND TOTAL PUBLIC REVENUES**

There are no simple metrics for measuring either how much decentralization a country should have, or for judging whether local governments in any given country have adequate funds to meet their expenditure responsibilities'. The main reason for this is that local governments perform different functions in different countries, and do so in different socioeconomic and institutional conditions. Further complicating matters is the fact that the budget classification systems and financial reporting practices of countries also vary substantially. As result, it's hard to compare revenue and expenditure patterns across countries without getting into fairly detailed analyses of what function local governments provide, and in what way their budget classification systems categorize revenues and expenditures.

For example, in one country, local governments may pay teacher's wages while in another country they are only responsible for maintaining school buildings, and in a third all education functions may be paid by the national government, etc. The chart below presents the share of local government revenues in Macedonia as a percentage of GDP and of total public expenditures.

**Chart 5. Local Government Revenues as % of GDP and Public Revenues**



Source: Annual Final Accounts of Municipalities in Macedonia, own calculations

In 2011 revenues of municipalities amounted to 5.70% of GDP, an increase compared to 5.58% in 2010. This progress is assessed as positive in comparison with the participation of local revenues in 2005 of 1.89%, when the process of decentralization began.

In September 2007, the first 42 local governments entered the second phase of decentralization and began receiving block grants for the social sector functions. The fact that they entered the second phase in the third quarter of the budget year explains why their revenues grow modestly in 2007, with the really dramatic increase coming in 2008 when their budgets come to constitute 4,7% of GDP and 13-14,1% of public expenditures. Then growth slows down as most of the other jurisdictions enter the second phase. By the end of 2010, all but 11 jurisdictions have assumed responsibility for social sector functions and total local government revenues rise to over 23 million MKD, or 5,5% of GDP to 5,7 % of GDP in 2011 or 26 million MKD.

The important things should be noted. The first is that total public spending on education in Macedonia is around 3 percent of GDP, after the factor in the wages of teachers spends more of the % of revenues. This puts Macedonia on the low side of European norms, where most countries spend to 5% of GDP on education. Or put another way, education has been decentralized but it probably also remains underfunded.

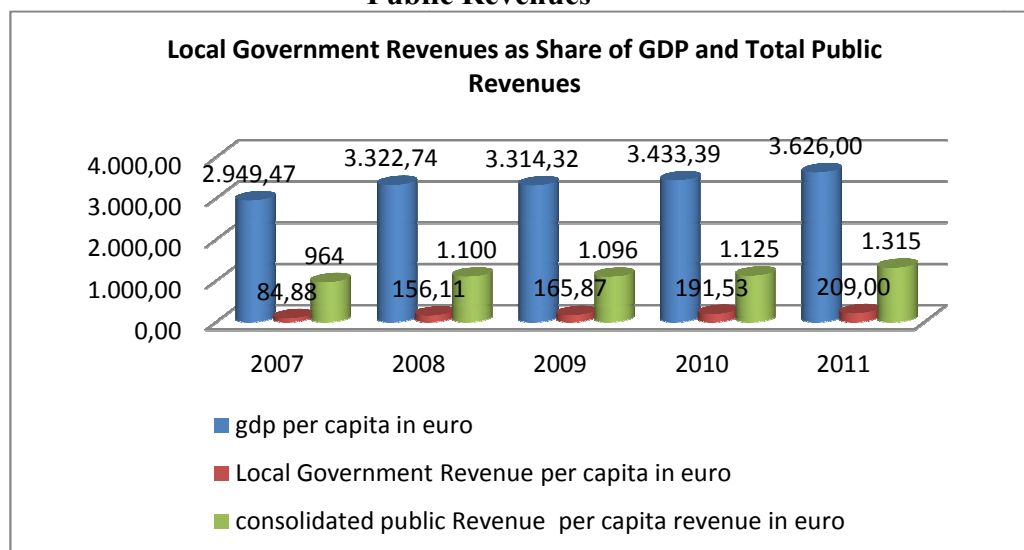
The second thing to be noted is that local governments are funding all their other expenditure responsibilities with revenues that are equal less than 2.6 percent of the GDP and less than 8,0 % of total public expenditures. Unfortunately, this means that local government revenues in Macedonia remain low, significantly lower as percent of GDP than those of other transitional countries in which local governments are responsible for teacher's pay-mentioned above! Moreover, if we remove education grants from the Macedonian figures, local government revenues as a percentage of GDP would be lower than 2,6 percent of GDP-than in all the countries in which local governments are not responsible for teacher's pay. Even if local government revenues rise 7 percent of GDP over the next 2-5 years, they would still be low in comparison to other countries in the region, given the fact that unlike most of them, Macedonians local governments pay teacher's wages. Even this sort of increase, however, will be extremely difficult under current economic circumstances. Nonetheless, that efforts in this direction must be made.

Central government total for these programs participate in the expenditure by almost 90% and most of the financing of primary education with 95.71% and least in cultural events and art . Municipalities have significant participation in fire protection with the participation of 24.69% and lowest in primary education from 1.91% (although there is an increase of 0.4pp. Compared with 2010. Most donations in 2011 has the musical and film archives activity, and at least secondary education. Most part of fundraising activities has the music and stage business to 24.71%. Credits for these programs municipalities have generated in 2011.

Local governments are also doing a better collecting their own revenues like communal fees tax which increased, revenues from the public lighting fee have also tripled, and the 2008 decision to double the maximum allowable rate made from the Law that was approved. Better collection, suggesting that here the local governments are taking their own revenues responsibilities more seriously.

Revenues from the very modest PIT share have not increased significantly. In part this is because the government introduced a flat 10 % personal income tax rate in 2007 and in part it is because the GDP actually declined in 2009, and did not fully recover to 2008 levels in 2010-2011. Meanwhile revenues from general VAT have increased from 463 MKD per capita in 2006 to 610 MKD in 2010. Here, it is important to note that the increase in the VAT share earmarked for the general grant and mandated by the 2008 amendments to the Law on Local Government Finance did not produce as much revenue growth as might have been expected because of the falloff in overall economic growth over the last few years.

**Chart 6. Local Government Revenues as Share of GDP and Total Public Revenues**



Source: Annual Final Accounts of Municipalities in Macedonia, own calculations

This should change as the economy improves and the share increases to its currently projected level of 4,5 % in GDP of national VAT yield in 2013, but as the economic growth is not rising this % will not recover the rising in real, because the national level of collected VAT in 2011 is lower.

The basic revenues of local governments have substantially increased since 2007. In large part the increase has resulted of policy decisions taken by the national government. It means the decision to double the base of public lighting fee, the extension of the property tax to legal entities, the amendments to the law on Local Government Finance that increased the size of the general grant, and the decision to begin sharing the revenue from the sale of urban construction land 80/20 in favor of the local governments. At the same time, local government basic revenues have increased because local governments have improved the collection fees, charges, and taxes, particularly the property tax.

The generally chart of revenue growth, obscures some serious issues about the equity of the intergovernmental system when we begin to look at how local government basic revenues differ across the entire population of Macedonian municipalities. As we see there is increasing of revenues per capita to the municipalities comparing 2007 with 2011 for 146%, but is very slower when we compare it with the public revenue per capita for example in 2011 local revenue per capita is 209 euro and public revenues are 1315 euro per

capita witch means that in generally the municipalities are underfunded if because the second phase of decentralization in Macedonia has entailed a massive shift in resources to local governments. But this shift has gone less to finance decentralizes functions than to provide municipalities with the money necessary to pay for state-run institutions that have been formally transferred to them.

## **CONCLUSIONS**

The second phase of fiscal decentralization in Macedonia increased municipal finances, the total revenues for municipalities in 2011 increased for 9.35% compared with 2010.

The highest growth is in funding loans from more than 12 times in 2011 compared with 2010. The own revenues of the municipalities grew for 14.60%. This financial trends is due to improved collection of own revenues and higher amounts of the ceded revenue from concessions of mineral raw materials and sales of construction land. There is increased interest in borrowing in financial institutions as a source of funding for capital investments, which are used, and the possibility of borrowing in the short or long term from the Central Budget of the Republic of Macedonia, overcoming the situation of lack of funds or time discrepancy for revenues and other receipts, expenditure and other outflows (lending in 2011 amounted to 1.82% of total revenues).The state block grant transfers to municipalities produce negative influence on Macedonian system of intergovernmental fiscal relations

The state don't transfer grants to the municipalities if the institutions are not given to the municipalities after decentralization. Only half of all Macedonian municipalities are receiving funding for functioning of pre-school education. Similarly, only 25 percent of municipalities had libraries or state-run theatres or cinemas prior to decentralization, meaning 75 percent of municipalities are currently receiving no grants for the function of culture.

The distinction between block grants and earmarked grant that informed the Law on Local Government Finance seems not to function as needed. The local government at first receives earmarked grants to support the non-wage operating costs of the function that were being decentralized to them, and then in the second phase of decentralization, receive freely disposable block grant that would allow them to allocate funds for wages and non-wage operating costs across functions as they saw fit.

This, however, is not really happening. It seems that local governments have limited administrative authority to change employment patterns in the institutions they have been assigned.

Few local governments who receive grants for decentralized functions contribute own revenues to support the costs of these functions. Contributions to the costs of decentralized functions remains under 3 percent, because the municipalities have underfunded transfer from VAT lower than 4 % PIT only 3%, and lower grant from the Road Fund, no criteria for transferring capital grants to each municipality from Central level. Also the transferred competences to the municipalities for secondary and primary schools aren't financially supported with the grants, because the risen expenses for paying the school transport to pupils which isn't taken in consideration when the central level transfers money to municipalities they are taking only the numbers of pupils in the schools, without taking any parameters in consideration with the risen expenses of oil, or heating, and % of pupils that needs to be transported from home to school and backward, which put municipalities in a very bad financial situation not to have enough grants transferred from the State to support the education system , according to brought Laws for municipalities.

(For example, lack of competence of city gyms, sports grounds (urban club pays rent to use the ground for making exercise, lack of cultural competence-building homes is not managed by the municipality but by the Ministry of Culture, boarding home managed by the Ministry of Education, and general mixing of the central government to municipal autonomy in the management of institutions such facilities exist within the municipality but not under the jurisdiction of the municipality).

In general, it will take many years for Macedonia to begin to provide local governments with equitable funding for decentralized social sector functions, simply because the national government does not have the funds to provide local governments that currently lack the associated institutions with money to create them. At the moment, there seems to be no plan for how to ensure that this process of fiscal decentralization moves forward in an orderly way, and that the existing differences in public services across municipalities does not worsen over time. Actually, the municipalities in the country are under-funded compared to municipalities in South-Eastern Europe.



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**UDC 338.1:336.52.025(497.7)"1997/2010"**  
**Original scientific paper**

**Elizabeta DZAMBASKA<sup>\*</sup>)**

**EMPIRICAL ANALYSIS OF THE EFFECTS OF PUBLIC  
EXPENDITURES ON THE ECONOMIC GROWTH**

**Abstract**

Public expenditures represent spending of funds by the State and other public and private bodies to finance the supply of public goods, but also to achieve other goals of economic and social policy. They represent public expenditure and as such category with private (household) consumption and the investment components of the total consumption in an economy. The volume of the public spending, as a rule, have to move within the amount of allocated funds for this purpose, i.e., within the amount of public revenues in the economy. Modern fiscal theory does not accept the view that public expenditures are good only when they are in a small amount, especially thinking that public expenditures are only a burden of the economy. Rather generally accepted view is that public expenditures are useful for the execution of the functions of the state, but with them, you can achieve certain economic and social goals. That is why when it comes to public expenditure as a financial category, it is especially important if they are productive, not what is their scope, large or small.

The level of public expenditure, in particular the trend of growth and their impact on economic growth are analyzed in this paper. Many empirical studies confirm the positive effect of increasing public expenditure on economic growth, but confirm that it depends on the structure and types of public expenditures. Empirical analysis refers to the trend of public expenditure in the Republic of Macedonia in the period from 1997 to 2010. To determine the impact of the different types of public expenditure on economic growth, multiple regression analysis is used.

The result confirms the weak influence of the public expenditure on the economic growth in Republic of Macedonia, especially if it is unproductive

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expenditures. Significant impact confirms the productive expenditure category as capital investments.

**Key words:** public expenditures; productive expenditures; unproductive expenditures; economic growth; multiple regression analysis.

**JEL Classification :** O11; O23; E6; E62

## **Introduction**

Macroeconomic analysis offer many different solutions about the size of the public expenditures. Theory and practice offer different approaches for the role of public expenditures. Existing evidence confirms or denies the impact of public spending on the economic growth of economies. Greater economic freedom and openness of the economies because of economic globalization have resulted in the increased public spending.

Especially the trend of rising levels of public expenditure is notable for the period from the 1960s in all 23 OECD countries. This trend of rising levels of public expenditure is present in the developing countries and economies in transition. The need for greater levels of public expenditure resulted from the growing role of the state in the functioning of the economy and so it consequently increased the participation of public expenditure in GDP.

The level of public expenditure, in particular the trend of growth and their impact on economic growth are analyzed in this paper. Many empirical studies confirms the positive effect of increasing public expenditure on economic growth, but also confirms that it depends on the structure and types of public expenditures. It is illusory to expect that the increase in unproductive expenditure category have positive effect on the rate of economic growth. On the other hand, the increase of productive expenditure category produces economic growth. Public spending on infrastructure: building roads, bridges, highways, ports and airports, building systems for telecommunications, expenditures for education, science, research and development, and health prevention and protection, increases the economic potential of the country. Thus, the works of Easterly and Rebelo (1993)<sup>1</sup> and more recent Canning and Pedroni (2004)<sup>2</sup> offer evidence of the effects on economic growth in the long term, associated with increased spending in public investment in the infrastructure of the economies. In fact, many analyzes of case studies

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<sup>1</sup> Andreas Irmen and Johanna Kuehnel, "Productive Government Expenditure and Economic Growth", University of Heidelberg, Department of Economics, discussion paper series no. 464, may 2008

<sup>2</sup> Ibid

emphasize the increasing potential for achieving growth in the economy caused by these types of productive expenditure.

There are empirical studies suggesting that the level of public expenditure, which exceeds the specified limit, and satisfies the basic functions of public expenditure, would have a negative impact on the economic growth (Dar & Amir Khalkali, 2002; Gallaway & Vedder, 1998).<sup>3</sup>

In this paper, by analyzing the structure and flow of public expenditure in the Republic of Macedonia, the influence on economic growth will be determined. We examined the data on public expenditure and GDP in the period from 1997 to 2010 year. The presented data of total expenditure refers to the consolidated budget of the Republic of Macedonia. The total expenditures of the consolidated budget includes expenditures of the central budget of local governments, expenditures of the Pension and Disability Insurance Fund and health insurance, and expenses of the Employment Agency of the Republic of Macedonia. From the presented data in Table no.1, clearly is shows the upward trend of total public expenditures. Also, in the Table.1 is illustrated the calculation of the share of total public expenditure in GDP. This indicator shows greatest increase in the period from 1998 to 2000, while from 2001 it starts to decline.

**Table 1 GDP and the total public expenditures of the Consolidated Budget of the Republic of Macedonia in the period 1997- 2010 in million denars**

Year	GDP in current prices (in million MKD denars)	Total expenditure	Total expenditure/GDP
1997	186.018	69.921	37,59
1998	194.979	79.314	40,68
1999	209.010	85.957	41,13
2000	236.389	98.191	41,54
2001	233.841	95.349	40,78
2002	243.970	87.485	35,86
2003	258.369	86.748	33,58
2004	272.462	88.169	32,36

<sup>3</sup> Peter Sjöberg, "Government Expenditures Effect on Economic Growth, The Case of Sweden 1960-2001", Luleå University of Technology, 2003

2005	295.052	100.219	33,97
2006	320.059	105.744	33,04
2007	364.989	117.455	32,18
2008	411.728	140.222	34,06
2009	410.734	139.393	33,94
2010	424.762	142.692	33,59

Source: State Statistical Office, Statistical Yearbook, 2000, 2002, 2003, 2004 and 2005; Ministry of Finance, Bulletin no. 2/2001, 3/2002, / 9-10/2003, March 2005, March-April 2007, July 2011<sup>4</sup>

## ENDOGENOUS ECONOMIC GROWTH THEORY

Theoretical explanation for economic growth usually tied to the aggregate production function, where the production factors determine the level of total realized production of an economy. Thus, the basic factors that determine economic growth are: labor, capital and productivity. Through the growth of any of these production factors, we achieve growth of total output of the economy or economic growth. The growth of labor as a factor of capital, is being determined by the natural rate of population growth. Thus, labor as a factor of growth is a relatively stable variable, with easily predictable increases. The increase in labor may be due to the increasing participation of the active population, as a higher proportion of working age population, which can occur because of extended active life of each participant of the active population, or by moving the minimum age limit for inclusion in this category. Another way of increasing the active population in an economy is the immigration, i.e. the inflow of labor from other countries.

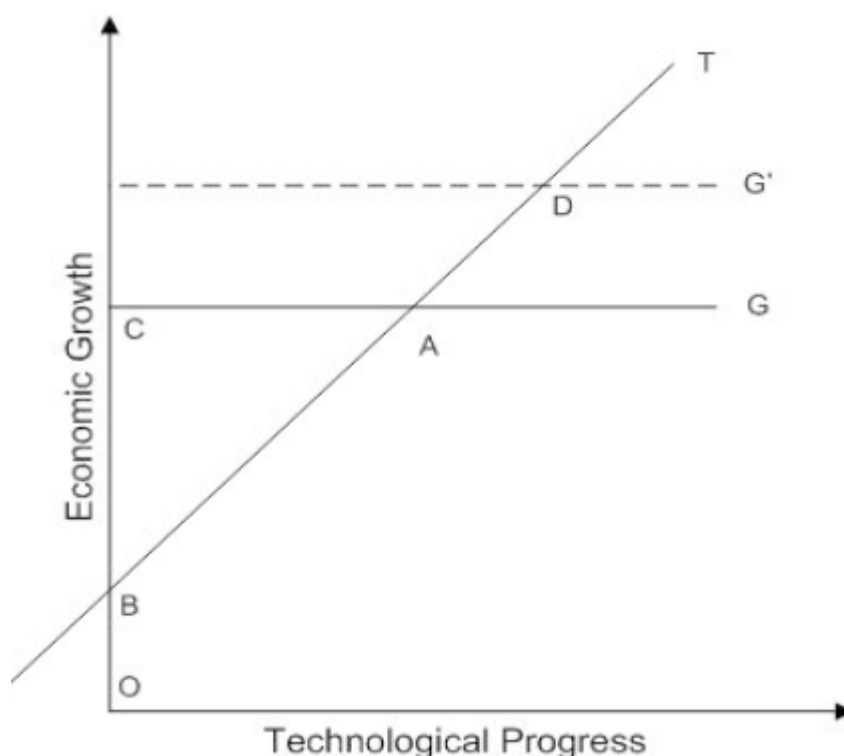
Growth of capital resulted from growth of physical capital and increased level of human capital in the economy. The physical capital increase in an economy increases the productivity of labor, effecting in total production increasing. Increasing the level of human capital is due to investment in human capital through formal and informal education. In addition, the acquisition of professional skills and capabilities through training and coaching during the working increases the level of human capital in the economy. The increase in total production, that cannot be explained even by increasing labor and capital,

<sup>4</sup> In the analyzed period in Macedonia, the system of national accounts was revised and expanded with new accounts in accordance with the needs of the Macedonian economy and with the methodological approach of the European System of Accounts. Such changes and improvements to the system of accounts complicate the study of the issue. So often we are faced with the situation, that the same kind of income or expenditure of the same calendar year (from the same source or from a different source of data) has different value. This research used data from these sources.

is the result of an increase in total productivity in the economy. In a word, it comes to productivity, resulting from the impact of various factors. Particularly emphasized is the impact of technological progress factor. Technological progress has two distinct phases of action on the overall productivity. The first technological progress creates an advantage in the level of knowledge, by creating new inventions and discoveries, inventions called second application, invention that leads to greater production efficiency called innovation.

Endogenous growth theory claims that technological development is an endogenous variable which can be affected on. According to the neoclassical theory, growth is a result of technological development that is an exogenous variable. Thus, under endogenous theory, the economic growth arises from accumulation of production factors. The only way through which the state (government) can effect the economic growth rise, in the long run, is throughout effects in investments, capital, education and research, and development. This economic model predicts stagnation and reduction of economic growth, when the public expenditure will increase and simultaneously cause crowding in the private investment. It resulted from the emergence of the so-called tax wedge. The government is forced to raise tax rates in order to provide more public revenues, that increased the level of public expenditure. This situation discourages the private sector to invest, primarily because of getting more revenues. Reductions in the tax incentives or tax exemptions are measures undertaken to accomplish the same goal (accumulation of funds to finance increased expenditure).

The effects of the undertaken economic activities, according to endogenous growth theory, can be summarized and briefly explained by the following chart.



**Figure 1 Endogenous growth: Determination of the Economic growth and Technological progress**

Source: Sjöberg Peter, (2002): Government Expenditures Effect on Economic Growth, Luleå University of Technology

The graph with the line marked G (growth) presents the rate of economic growth. The explanation is towards the impact of three key variables: the rate of savings, efficiency, and depreciation (the rate of depreciation, wear of capital). The curve marked T represents technological progress, that is the main feature of the endogenous model of economic growth. Technological progress is always in step with the rate of economic growth, and shows a proportional relationship. The growth of technological development is accompanied by an increase in the rate of economic growth, and achieved higher levels of economic growth provide greater technological development. Point B represents the rate of natural population growth in the economy. The intersection of the curves T (technological development) and G (the level of economic growth) shows that the economy is in a state of equilibrium, in the long run. In this state of balance, the economic growth is equal to the distance shown by the points O and C,

represented on the vertical axis. According to the displayed, the economic growth can be considered that resulted from the natural population growth (the distance on the vertical axis OB) and technological development (the distance on the vertical axis of the points B and C). Assuming that the rate of savings in the economy increases, the rate of economic growth should increase, too. This graph shows shift of the curve G at a higher level in G'. The point of balance, now, moves up and is denoted by D. The level of natural population growth remains the same, which shows that the most economic growth is result of greater amounts of capital that is accumulated through the technological progress acceleration within the learning process. Disadvantage of this model is inability to explain the timeline of events of these changes. It does not explain how fast these processes happen.

The Graph will be used to explain development in the economy in the second case, when a key variable that changes is the increase of efficiency. By definition, the efficiency is when using the same level of resources (factors of production) a higher level of total production is achieved, i.e. higher GDP. For example, better education can be a way of increasing the use of improved factor capital. Increased efficiency in the use of this factor of production allows achieving higher total income of individuals in the economy. The realized higher income is a prerequisite for increase of the level of savings of individuals, that in turns resulted to a higher rate of savings in the total economy. From the above, we learn that the higher savings rate shifts the curve of the rate of economic growth upwards, and above the point G in G' on our chart. The given level of savings turns the efficiency of economic growth, but also a certain level of efficiency of the economy is a prerequisite for increasing savings and achieving economic growth. Actually, this shows that efficiency and savings have the same effect on the economic growth, as well as the technological progress.

The third significant variable in the endogenous model, that explains the economic growth, is the rate of depreciation or amortization rate of capital. The gross investment of an economy should never be a negative number. By definition, the gross investment is the sum of net realized investment in the economy, and the depreciation of the existing capital (depreciation rate of capital spent). If the gross investment is at a level that only replace the old capital, then, it is a negative net investment. Thus, depreciation of capital reduces the level of capital in the economy, and in the absence of net investment, the economic growth will stagnate and will have negative values. On our graph, this situation is explained by the shift of the curve of the rate of economic growth G' in G, when the rate of depreciation of capital exceeds the rate of gross investment in the economy. The point of balance moves from D to A. Then economic growth and technological progress slows down.



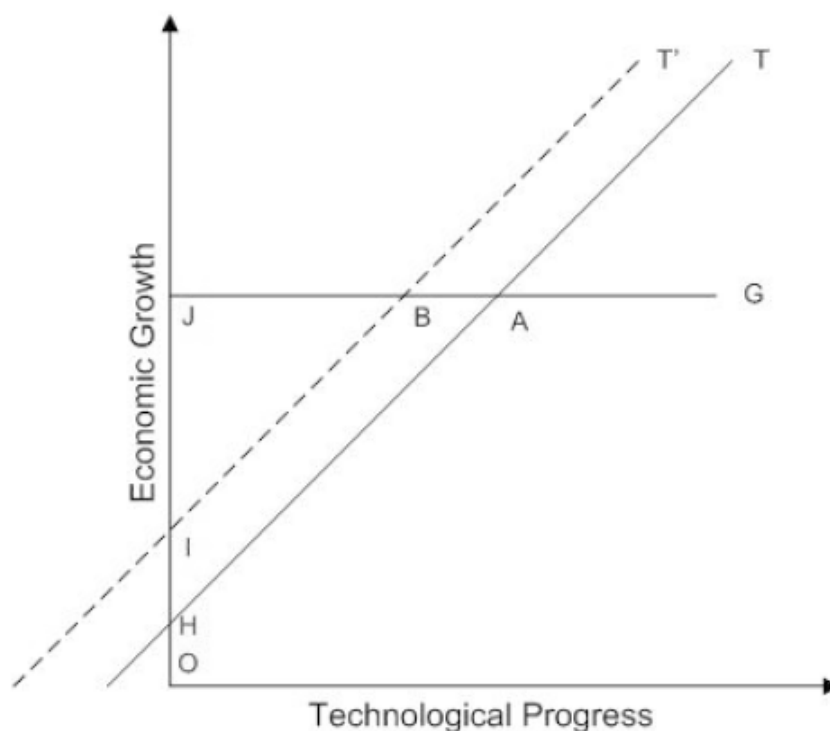


Figure 2 Endogenous growth: Increases of population Growth Reduces Technological Progress, but leaves Economic Growth Unchanged

Source: Sjöberg Peter, (2002): Government Expenditures Effect on Economic Growth, Luleå University of Technology

The graph number 2 shows the state of the economy when the changing factor of production is labor. Thus, the growth rate of natural increase of population shifts curve of technological progress  $T$  on the left, and top of the curve  $T$  in  $T'$ . With the most of the population growth rate, the economic growth remains at the same level, as the new equilibrium is the same curve in the rate of economic growth in the point  $B$ , but is the result of greater engagement of the factor of production labor, and less on technological progress. The rate of population growth increased from  $OH$  in  $OI$  distance shown on the vertical axis of the graph, and the contribution of technological progress to economic growth decreased the distance of the points  $IJ$ . The difference in the economy, due to the increase in the rate of growth of

population, is reflected in lower GDP per capita, which in the graph refers to the distance IJ, rather than the previous HJ (shown on the vertical axis).

## **EMPIRICAL ANALYSIS**

According to the previously discussed in the empirical section, it will be taken into account that the variables should provide us confirmation of the theoretical explanation of the endogenous model of the economic growth. The aim of the empirical research in the paper is to show whether there is a significant relationship between the level of achieved economic growth, and the level of public expenditure, and differences in structure. The used multiple linear regression analysis, where the dependent variable takes the achieved level of GDP, and the dependent variables represent different categories of public expenditure, public expenditure, the level of public investment, the amount of transfers, capital expenditures, etc. in order to determine whether there is interdependence, and how are these variables.

The analysis took into consideration only data of public expenditures of the consolidated budget of the Republic of Macedonia. For this purpose, the applied database for Macedonia were taken from official data sources for these categories from the State Statistical Office of the Republic of Macedonia, the Ministry of Finance, and the National Bank of the Republic of Macedonia, as well as the UNECE Statistical Division Database, compiled from national and international databases such as CIS, EUROSTAT, IMF, and OECD.

In the model, the dependent variable is the realized GDP at current prices, and determines the impact of independent variables of household final consumption (private consumption), final consumption state (public spending), and gross investment and government transfers. All data refer to the period from 1997 to 2010, and are expressed according to the current prices in million.

The made regression gave the following equation. (The obtained results are presented in Annex no. 1)

$$y = -1711,7552 + 0,9134x_1 + 1,2291x_2 + 0,0507x_3 + 0,3301x_4$$

According to the results of the regression coefficient of multiple straight-line regression (Multiple R) is 0,9983, which confirms that there is a stronger correlation- relationship between the observed phenomena. The multiple straight-line regression coefficients (R Square), and the corrected coefficient of multiple determinations (Adjusted R Square) amounts to 0,9966 and 0,9950, respectively. The standard error of regression is 5862,42, with the deviation between empirical data and a theoretical or expected value obtained from regression is 3093312128,3 and is called unexplained deviation. On the other

hand, part of the deviation that can be explained by the set regression relationship between the dependent variable and the following independent variables is called the explained deviation or residual amounts 309312128,3. The total statistical tolerance is 89962681159, and the sum of explained and unexplained deviation. This is because the empirical data are characterized with enhanced dispersion or their sizes affect the size of the sample, which is subject to regression. In our example, we can conclude that higher statistical deviation is a result of only the analyzed sample size, a series of 14 observations. The analysis restricted only to this database within a relatively short period of time, and due to the unavailability of data series from methodological aspect.

The first variable that is examined in the regression model is the private consumption. Setting hypotheses and their testing will indicate whether the variable (private consumption) affect the dependent variable Y (the level of realized GDP). P-value of the tests of significance of the parameter  $b_1$  is less than the significance level (0,01 or 0,05), which means it shows the significance of the two levels. The realized value of the t-test value for this variable is 6,0034, while the critical value of the significance level  $\alpha = 0.05$  and the number of degrees of freedom  $(n - K - 1)$  according to the Student t-schedule is 3,250. Since the realized value of the test is greater than the critical value,  $6,0035 > 3,250$  rejects the null hypothesis  $H_0 : b_1 = 0$  and accept  $H_1 : b_1 \neq 0$ . This confirms that there is a straightforward relationship between the analyzed variations and simultaneously conclude that the private consumption affects the economic growth. According to the specified  $b_1$  parameter, confidence interval  $\alpha = 0.05$ , 0,5692 and 1,2576, we can predict that an increase in the private consumption within this interval values can increase GDP.

The second variable  $x_2$  is government consumption and obtained indicators conclude that the testing of the two hypotheses,  $H_0 : b_2 = 0$  and  $H_1 : b_2 \neq 0$ , the first hypothesis is accepted and there is no straightforward relationship between the public spending and the economic growth. In this case, the t-value is  $3,1384 >$  from the amount of t-3,250 schedule. Confidence interval of the parameter  $b_2$  ranges from 0,3432 to 2,1150 would be interpreted as an increase in public spending for 1000 MKD denars, on average it can be expected to increase GDP at least 343,2 to 2115 MKD denars, with a coefficient reliability of 0,95. The analysis and testing of the t-distribution of the other two independent variables  $x_3$  (gross investment) and  $x_4$  (transfers) give different results. The calculated value for t-test  $x_3$  variable is 0,1031 and compared with critical value at a significance level  $\alpha = 0.05$  and the number of degrees of freedom  $(n - K - 1) = 9$ , according to the value in table 3,250, the hypothesis

$H_0 : b_3 = 0$  is accepted, since  $0,1031 < 3,250$ . Variable  $x_4$ ,  $t = 1,4772 < 3,250$ , by which it also accepts the first hypothesis  $H_0 : b_4 = 0$ .

The second threshold test our hypotheses through a p-value confirms the decision to accept the first hypothesis, p-value variables respectively amounted to 0,9201 and 0,1737 and higher than the level of significance of 0,01 and 0,05. Briefly summarized, we are taking into account the level of significance of 0.05. Independent variables gross transfers do not affect the dependent variable GDP. This conclusion variable table is very logical, because the transfers as a category does not apply to create new value in the economy, but are already realized income redistribution. Hence, it is not surprising, the result that transfers as a category does not affect the realized level of GDP in the Republic of Macedonia. The conclusion is confusing, it gets that the gross investments significantly affect GDP in the Republic of Macedonia. This can be interpreted because of the whiskey percent depreciation of capital in the economy, and the level of gross investment, which is mostly used to cover the high rate of depressed capital, and a very small part of a new net investment.

To be able to see the impact of public investment category in multiple regression straight line so far, as an additional independent variable, we use data on capital expenditures in the Republic of Macedonia, as a proxy for the public investment. The new regression analysis covers the same period from 1997 to 2010. With the addition of a new independent variable changed and parameters obtained, simultaneously is increased the standard error in the regression. The new regression standard error is 6182,25. (Annex no. 2)

The testing hypotheses, according to the value of the t-test and p-value, here confirms the previous concluded that, in the variable private consumption there is a straightforward relationship between the analyzed variations, and simultaneously conclude that the private consumption affects the economic growth. Different is the result of the public spending, where the results show that the public spending significantly affect GDP. The same conclusion applies to the variables of gross transfers. New variable in the regression analysis, the capital expenditure shows an inverse (negative) relationship with GDP, since the coefficient  $b_5 = -0,3625$ . The absolute value of t-test  $0,3048 < 3,250$  suggesting the conclusion that the capital expenditures significantly affect GDP.

The confidence interval for  $b_5$  the ratio range  $-3,1050 < b_5 < 2,3801$ . This could be interpreted as any increase in capital expenditures for 1000 MKD denars will affect the reduction in GDP of 310 MKD denars to a maximum increase of 238 MKD denars. This is an indication of an insignificant impact of the capital expenditure in the Republic of Macedonia in the analyzed period.

## **CONCLUSION**

The empirical analysis of the public expenditure impact on the economic growth in the Republic of Macedonia, contains the results of multiple regressions, in which one is the regression where the dependent variable is the realized GDP at current prices, and determine the impact of independent variables household final consumption (private consumption), final consumption state (public spending), gross investment and government transfers, and the second regression ,except the aforementioned independent variables in the analysis, includes the variable of capital expenditures. The results show that the private consumption positively affects the economic growth, while the public consumption, gross investment and transfers have no effect. The capital expenditures, that are emerging as an important category of expenditure on economic growth, in the case of the Republic of Macedonia, did not show significant impact. Therefore, I suggest applying of the measures of public expenditure policies that will increase the share of capital expenditure in the total expenditure in the Republic of Macedonia.

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**Annex No. 1** - Multiple regression GDP, household final consumption (private consumption), final consumption state (public spending), gross investment and government transfers in the Republic of Macedonia in the period 1997-2010

## SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0,998279406
R Square	0,996561773
Adjusted R Square	0,995033672
Standard Error	5862,423924
Observations	14

## ANOVA

	<i>Df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	4	89653369031	22413342258	652,1570344	4,49412E-11
Residual	9	309312128,3	34368014,26		
Total	13	89962681159			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95,0%</i>	<i>Upper 95,0%</i>
Intercept	-1711,755234	15544,01637	-0,110123098	0,914728253	-36874,76321	33451,25274	-36874,76321	33451,25274
X Variable 1	0,913438364	0,152152002	6,003459367	0,000201642	0,569246622	1,257630105	0,569246622	1,257630105
X Variable 2	1,229115293	0,39163251	3,138440403	0,01195802	0,343181005	2,11504958	0,343181005	2,11504958
X Variable 3	0,050686211	0,491599766	0,103104628	0,920140798	-1,06138972	1,162762143	-1,06138972	1,162762143
X Variable 4	0,330070954	0,223448862	1,477165518	0,173746548	-0,17540549	0,835547399	-0,17540549	0,835547399

**Annex No. 2** - Multiple regression GDP, household final consumption (private consumption), final consumption state (public spending), gross investment, government transfers and capital expenditures in the Republic of Macedonia in the period 1997-2010

SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0,99829917
R Square	0,996601233
Adjusted R Square	0,994477004
Standard Error	6182,254467
Observations	14

ANOVA

	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	5	89656918996	17931383799	469,1590001	1,19918E-09
Residual	8	305762162,4	38220270,3		
Total	13	89962681159			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95,0%</i>	<i>Upper 95,0%</i>
Intercept	-2722,054324	16723,87917	-0,162764529	0,874740126	-41287,3888	35843,28016	-41287,3888	35843,28016
X Variable 1	0,921026037	0,162372888	5,672289552	0,000469155	0,546593486	1,295458588	0,546593486	1,295458588
X Variable 2	1,228376543	0,413005536	2,974237474	0,017755897	0,275984069	2,180769017	0,275984069	2,180769017
X Variable 3	0,128028742	0,577201703	0,221809363	0,830019667	-1,203000772	1,459058256	-1,203000772	1,459058256
X Variable 4	0,28352724	0,280801155	1,009708243	0,342195604	-0,364001383	0,931055864	-0,364001383	0,931055864
X Variable 5	-0,362464829	1,189325298	-0,304765088	0,768322906	-3,105053883	2,380124225	-3,105053883	2,380124225

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**Original scientific paper**

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## **METHODOLOGY FOR DETERMINING ORGANIZATION'S DEVELOPMENTAL STAGE**

### **Abstract**

The organizational life cycle, together with its internal needs and transformations, is crucial in planning and implementation of the management activities. The implementation of positively verified methodologies conducted in a wrong developmental stage can have catastrophic consequences for the organization.

In this study a methodology for determination of organizational developmental stage is presented. The methodology uses a new designed questionnaire consisted of questions focused on organizational orientation; structure and functionality; delegation of responsibilities and authorizations; finances and costs; development policy and owner - company relationship. The questionnaire is answered by the top management. The developmental stage is determined with comparison of obtained responses and theoretically anticipated normal problems by development stages.

The results showed that the analyzed organization is in the transition period between Go-Go and Adolescence stage. Based on the results and in order of successful continuing of the developmental path, recommendations for future management actions are given.

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**Key words:** organizational life cycle, development stage, management, questionnaire, organization

**JEL classification:** M10, M14, L53

## Introduction

The beginning of every organization is just an idea. The path that will lead from idea to realization, from being to persistence, from group of people who work on achieving a goal to structured organization with determined organization objectives, is long and complex. There for, the development path of the organization and its internal needs and transformations is of crucial importance in planning and implementing management activities.

Numerous researchers that were exploring the organizational development have adopted the concept of “being” in the biological sense of its meaning and suggested models of life cycles of organizations from birth to death. Models differ depending on the number of stages of the organizational life cycle, criteria used as basis in dividing the development stages as well as their application. Models depending on the number of defined development stages vary from a model with three like Downs model to a model with ten defined development stages like the one developed by Isach Adizas.<sup>1, 2</sup> Some of the researched models are applicable only in small organizations and some only in big organizations.<sup>3, 4</sup> Lester's organizational life cycle model is formatted in

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<sup>1</sup> Downs, A., The life cycle of bureaus, in Downs, A. (Ed.), Inside Bureaucracy, Little, Brown, & Co., San Francisco, CA., 1967

<sup>2</sup> Adizes, I., Organizational passages: diagnosing and treating life cycle problems in organizations, Organizational Dynamics, Vol. 8 No. 1, 3-24, 1979

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<sup>5</sup> Lester L. D, Parnell J. A, Carraher S., Organizational life cycle: a five-stage empirical scale, The International Journal of Organizational Analysis, Vol 11. No. 4. 339-354, 2003

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<sup>9</sup> Adizes Isach, Upravljanje zivotnim ciklusom preduzeca, Novi Sad, ASEE, 2007

<sup>10</sup> Janićijević N., Bogićević Milikić B., Organizational growth of SMEs in Serbia: governance as a built-in limiting growth factor, Sociologija, Vol. LII, N° 2, 168-180, 2010

<sup>11</sup> Adizes Isach, Upravljanje promenama, Novi Sad, ASEE, 2008

five stages –existence, survival, success, renewal and decline.<sup>5</sup> This model and the methodology of determining the development stage are used in numerous further researches. Some of them are the researches on the relation of the organizational life cycle model with the organizational performances in small and middle enterprises and the influence of the information technology capabilities on the organizational life cycle development stage of small and middle enterprises.<sup>6,7</sup> The organizational life cycle is also researched from the aspect of its relation with the problems of the human resources management in small and middle enterprises<sup>8</sup> and with the management structure.<sup>9,10,11</sup>

This research is using the organizational life cycle theory of Isach Adizas. According to this theory, the optimal life cycle of the organizational development includes the following growing stages – Courtship, Infancy, Go-Go, Adolescence, and Prime. After reaching the stage of Prime, the organization will stay in the stage of Stability or it will start its aging through the stages of Aristocracy, Early Bureaucracy, Bureaucracy and Death. In each of the stages of growth, the organization is facing a set of challenges that in theory are classified as normal problems (changeable by nature). If these problems are not identified and dealt in time, they intent to transform into pathologic problems that may cause death of the organization at any time. To optimize the life cycle course, knowledge and consultations are needed for more effortless overcoming of the normal problems anticipated for each of the development stages. The most important stage for optimization is the stage of Stability that restrains aging of the organization.

The goal of the research presented in this paper is establishing a methodology for determining the development stage of an organization. Successful determination of the organizational development stage will provide knowledge about which organizational functions need to be transformed and in which direction. Based on this knowledge, the management will be able to define the priorities that require its focus and more objectively select activities for implementation that will have real prospect in giving positive effects. This provides the preconditions for optimization of each stage of the organizational development course. The optimization minimizes the potential for transformation of normal problems into pathologic problems and in the same time increases the potential for maintaining and persistence of healthy organization.

## **1. METHODOLOGY**

The research is conducted in a Macedonian organization that consists of three production plants, and by ownership structure is a holding company. The organization accounts 600 employees and top management executive board of

five members. The organization is established in 1927, but it functions with changed ownership structure since 1991 when from state owned it was transformed into privately owned company.

For the purpose of the reaserch, a questionnaire for determination of the organizational development stage was created.<sup>12</sup> The questionnaire is consisting of 13 questions accompanied with two or three obtainable answers for each question. The questions are based on the normal problems anticipated in each development stage of the organizational life cycle. The questionnaire used for determining the development stage of the organization is filled by the members of the top management.

The obtained answers of this questionnaire are compared with theoretically anticipated normal problems by development stages. The development stage of the organization is determined by the record of which development stage has the most coincidence between the theoretically anticipated normal problems of the development stage and the collected answers. Because of the fact that all structural parts of an organization don't develop equally, the transition from stage to stage doesn't happen in the whole organization at once. Accordingly, coincidences in two subsequent development stages can be expected. In that case, the organization is placed in the transition between those two subsequent stages.

## 2. RESULTS AND DISCUSSION

Summary of the questions, obtainable answers and obtained answers from the application of the newly designed questionnaire are given in Table 1.

**Table 1 Questionnaire summary**

No.	Question	Provided answers	Answers received
1	What is the company orientation	Product, market or development vision	Market
2	Are the jurisdictions clearly defined, elaborated in details in written form	Yes or no	Yes
3	Are the jurisdictions within the company delegated	Yes or no	Yes
4	Is the responsibility that is coming		

<sup>12</sup> Šanevska N., Integral model for projecting sub-system of motivation in the system of quality management, master work, TMF, Univ. Sv.Kiril i Metodij, Skopje, 2012

	out of the delegated jurisdictions in harmony with the received authorities	Yes or no	Yes
5	What is the organization structured set on	People or processes	People
6	Are there formally defined systems for functioning of the company	Yes or no	No
7	Is there a clear and formally defined development policy with defined activities and time frames	Yes or no	No
8	Is the implementation of the development policy followed by evidencing remarks regarding implementation	Yes or no	No
9	Is the company financially stabile	Yes or no	No
10	Does the company have full control over the costs	Yes or no	Yes
11	Is the company undertaking frequent investments	Yes or no	Yes
12	Is the founder of the company accepting the sovereignty of the company	Yes or no	Yes
13	How do you evaluated the interpersonal relations in the company	Positive or negative	Negative

Table 2 gives an overview of the most specific normal problems by development stages of the organizational life cycle. This table was created in order to compare the obtainable answers with the theoretically anticipated normal problems. The stage of Prime is excluded from the overview because it's supposed to be without any specific problems. This stage is an optimal condition of balance between the capacity of the company to control the processes and its feasibility, which needs to be constantly maintained through the stage of stability.

**Table 2. Summary of the theoretically anticipated normal problems by development stage**

<i>Development stage</i>	<i>Theoretical anticipated normal problems</i>
<b>Courtship</b>	Extreme determination of the founder of the company for undertaking risks, company orientation only to the product, the founder has the full control
<b>Infancy</b>	Company orientation only to the product, negative flow of money,

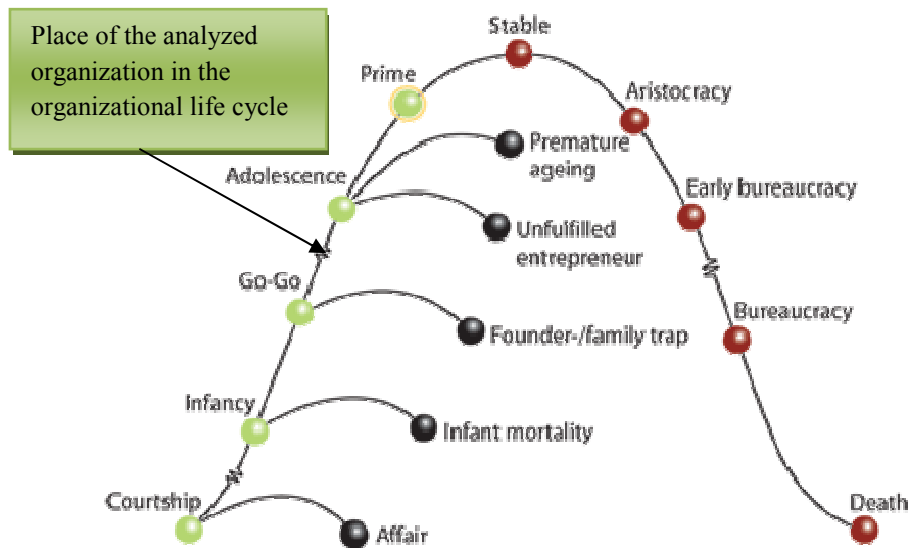
	not enough systems in the organization, no delegation of jurisdiction, lot of production defects, benevolent dictatorship by the founder of the company
<b>Go-Go</b>	Extreme self-confidence, company orientation only to sales, insufficient control over the costs, no rewarding system, the management is distancing from the employees and has growing expectations, the jurisdictions are unclear, internal disintegration, the founder of the company is irreplaceable
<b>Adolescence</b>	Temporary loss of vision for development, the rewarding systems are stimulating wrong attitude, the jurisdictions are miss delegated, the business policy is not respected, the profit is growing – the sales stagnate, the founder of the company is accepting the company sovereignty

The coincidences of obtained answers from the questionnaire (table1) and the development stage are noted in Table 3. The coincidence is determined by comparing the obtained answers with the theoretically anticipated normal problems by development stage (table 2).

**Table 3. Comparative analyses of the obtained answers from the questionnaire with the theoretically appointed normal problems by development stage**

<i>Question number</i>	<i>Development phase</i>				
	<i>Courtship</i>	<i>Infancy</i>	<i>Go-Go</i>	<i>Adolescence</i>	<i>Prime</i>
1			X		
2			X		
3				X	
4				X	
5			X		
6			X		
7			X		
8			X		
9			X		
10				X	
11			X		
12				X	
13			X		

Table 3 shows that the coincidences of the obtained answers in most of the cases are recorded in Go-go stage and a smaller number of records are noted in the stage of Adolescence. This indicates that the organization is in Go-go stage of development, with certain elements of Adolescence stage. It can be concluded that the organization is in transition between this two stages (Figure 1)



**Fig. 1. Development stage of the analyzed company**

Source: Adizes Isak, Upravljanje zivotnim ciklusom preduzeca, Novi Sad, ASEE, 2007 (modified)

Because of the exceptional sensitivity of this period it is recommended for the analyzed organization to pay special attention to the following elements:

- Reconstruction of the organization through designing and implementing systems for its functioning. For achieving this it is necessary to define the processes in the company and the organization structure to be set around those processes and not around people.
- Redefining and institutionalizing of the authorizations and responsibilities of the employees through organizational rules and politics. In the reconstructed organization it will be much easier to institutionalize the authorizations and responsibilities in order to provide monitoring of the effectiveness and efficiency of work. Rules and politics should be clear and precise, and their fulfillment evidenced.
- In the reconstructed and formalized organization a careful change of the organizational objectives is needed. In this stage of organizational development one of the objectives is the change of organization focus from market to product. All the changes must be based on precise information

acquired by analysis of the process data. This will help in decreasing the potential for overtaking investments that have disproportional risk, which will bring increased financial stability to the company.

- Improvement of the internal integration of the company by introducing a transparent rewarding system will provide successful implementation of previously given suggestions.

## **CONCLUSION AND FURTHER RESEARCH**

The development stage of the analyzed organization is determined by using the newly created questionnaire. Based on the determined development stage, suggestions for the directions and focus of the further management actions are given. Installing the recommended activities will stop the emergence of pathological problems and will provide successful transition from Go-Go to Adolescence stage.

The organizational development path is something that every organization must go through. The emergence of problems in each phase is inevitable, and the optimization of the development path is crucial for sustaining effective and efficient organization. Realization of this goal requires knowledge of what needs to be done and in which direction the activities must be undertaken. The presented methodology provides that kind of knowledge and with it the preconditions for optimization of the development stage and further development path of the organization to the stage of Prime, which is necessary for the organization to stay competitive on the market.

The application of the presented methodology on a wider sample should be considered as a potential for further research. Such a research is best to be conducted over a sample of organizations that are in a same business in order to provide completeness of the results analysis. The research will re-examine the functionality of the presented methodology and will review the used concept of questioning and evaluating. It is expected that the analysis of the results will open a new possibility for generalized determination of the development stage of organizations in a same business. Besides getting directions for management action in the analyzed organizations, a possibility for accomplishing a general strategy for optimization of organizational development in the selected business is expected.

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**Professional paper**

**Mira STANKEVIK SHUMANSKA\*)**

**REALIZED INVESTMENTS IN MANUFACTURING OF  
WOOD AND WOOD PRODUCTS AND FURNITURE  
PRODUCTION IN THE REPUBLIC OF MACEDONIA**

**Abstract**

Investments represent a prime mover of the economy. Without them it cannot talk about economic development in general of the each country. The realized investments of the Macedonian manufacturing have decrease tendency with the average annual rate (AAR) from -0,2% for the period 2007 - 2010. This trend follows the investments in the furniture production with AAR from -1,5%, unlike the manufacturing of wood and wood products where the gross fixed capital formation by purpose of investment show growth from 32,6% for the analyzed period. The investments of wood and wood products manufacturing participate with about 0,2% and also furniture production with 0,7% in the total manufacturing investments of the Republic of Macedonia for the same period. The technical structure (buildings and structures and machinery and equipment) of investments in total (manufacturing of wood and wood products and furniture production) beside fluctuation is favorable. This is the result of the average investments in buildings and structures from 32,0% and machinery and equipment with 68,0% for the period 2007 - 2010. The favorable investment technical structure is distinctive for the manufacturing of wood and wood products and furniture production too. Small participation of investment in the woodworking industry in relation to the total investment in the economy of the Republic of Macedonia and the disinvestment level of the industry as a central activity requires the investment in the sector is very small and given that no significant outcomes. Foreign investments of the Republic of Macedonia as an additional impulse for development are insignificant. Foreign direct investments by the activity of investing have variable dynamic with positive AAR for the period 2003 - 2007. The foreign investments of the manufacturing participate with only 25,0% in the total foreign investments of the Republic of Macedonia for the analyzed period.

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**Key words:** investments, technical structure of investments, foreign direct investments, manufacturing of wood and wood products, furniture production

**JEL classification:** E, E2, E22

## **Introduction**

Investments represent the most commonly used terms by economists, researchers and scientists in the field of economic sciences, as well as in everyday practice. These like an important mover of the ultimate goal of economic development, with its three dimensions: volume, structure, and efficiency represent an inexhaustible interest of theoretical and applied research on economic science and practice.

Economic theory and practice indicate that investment policy represents the axis on which relies development policy. That is the basis of thesis that investments is vertebral column of the development policy, and these are the lifeblood and catalyst for economic development of each country.

The problems in the field of investment in the Republic of Macedonia resulting from low accumulative capacity of the economy of the country, even in characteristic before transition period, which completely deteriorated on one side, and the lack of support by the foreign investments, from the other side. The volume of investment is quite insufficient to initiate changes in the structure of the economy of the Republic of Macedonia, which is the necessary condition for the realization of the transition processes in the past. Small scale investment characteristic of underdeveloped countries determines the structure of investments: they are mainly concentrated in a small number of industries, basic industries, in new capacities, infrastructure objects. This is the case with the Republic of Macedonia before transition and in transition period. Investment policy ignored activities that create new values, that is in a better position activities of the tertiary sector and non-manufacturing activities, which should undoubtedly be taken into consideration and the absolute volume of investment.

Foreign capital of any kind means harder linking of the national economy with the corporate world, which creates an opportunity for the introduction of new technologies, increasing productivity and quality of products, conquering new markets, increasing domestic competition, and thus the overall quality of economy in the country. Although critically needed foreign direct investment as best kind of transition funding in recent years, for our country were extremely poor in terms of our needs and compared with the inflow of investments in other transition countries. Foreign direct investments in the Republic of Macedonia amounted to an annual average 100 millions US \$ in the period 1993 - 2003. It

was not an investment in new capacities, but for the most part financial investment to take the dominant property in the country's significant economic capacity.<sup>1</sup>

The state of investment both in volume and in structure has a significant impact as the total Macedonian economy, and for the woodworking industry or the manufacturing of wood and wood products and furniture production, as an integral part of the economy of the Republic of Macedonia.

## **1. AIM OF RESEARCH**

By analyzing the data in this paper we are looking at the situation in terms of investments at the manufacturing of wood and wood products and furniture production in the Republic of Macedonia. In this case the direction of observation are realized gross fixed capital formation by purpose of investment and technical structure of investment in the woodworking industry and by individual types of productions. It is also made an analysis of data for foreign direct investment by the activity of investing aimed to considering foreign investment in the domain of the manufacturing in the Republic of Macedonia.

## **2. RESEARCH METHODOLOGY**

The data for the investment condition in the woodworking industry analyzed using the method of mathematical analysis. In our analysis the trends of increase and decrease of the appearance calculated using an annual average rate (AAR) of increase and decrease for the given period. The realized gross fixed capital formation by purpose of investment data for the period 2007 - 2010 according the National Classification of Activities are obtained from State Statistical Office of the Republic Macedonia publications. Data refer to investment as manufacturing and woodworking industry separately by type of production. Analysis is also performed the technical structure of investment in percentage participation, to the woodworking industry in total, as well as individually for the manufacturing of wood and wood products and furniture production in the period 2007 - 2010.

It is also analyzed and foreign direct investment in manufacturing, as well as at the state level using the data obtained from the State Statistical Office of the Republic of Macedonia publications in the period 2003 - 2007.

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<sup>1</sup> Станкевиќ, М.: Анализа на некои аспекти од развојот на дрвната индустрија во услови на транзиција - состојби, проблеми, перспективи, докторска дисертација, Шумарски факултет, Скопје, 2007, стр. 25

### 3. RESEARCH RESULTS AND THEIR ANALYSIS

Table 1 shows the data for realized gross fixed capital formation by purpose of investment, in million MKD denars, at manufacturing and woodworking industry, respectively in manufacturing of wood and wood products and furniture production in the period 2007 - 2010. The investments are realized in enterprises of private, state, cooperative and mixed - owned sector.

**Table 1. Realized gross fixed capital formation by purpose of investment, for the period 2007 – 2010**

<b>Year</b>	<b>Manufacturing (in million denars)</b>	<b>Manufacturing of wood and wood products (in million denars)</b>	<b>Furniture production (in million denars)</b>
2007	10389	9	67
2008	13473	31	142
2009	14535	30	51
2010	10327	21	64
<b>Average</b>	<b>12181</b>	<b>23</b>	<b>81</b>
<b>AAR</b>	<b>-0,2</b>	<b>32,6</b>	<b>-1,5</b>

Source: State Statistical Office of the Republic Macedonia, Publications: Gross Fixed Capital Formation (2007, 2008, 2009, 2010)

According to the data from the Table 1 we can see that the realized investments in manufacturing have decline tendency with the annual average rate (AAR) from -0,2% in analyzed period.

The realized gross fixed capital formation by purpose of investment in the manufacturing of wood and wood products fluctuate from year to year for the given period (Table 1). Beside fluctuation the investments noted positive trend with annual average rate from 32,6%. In the manufacturing of wood and wood products was invested about 23 million denars annual average for the analyzed period.

The investments in furniture production also have fluctuation during the years for the given period (Table1). As the result of fluctuation the investments

have negative tendency of decrease with annual average rate from -1,5%. The investments in furniture production are 81 million denars annual average for the same period.

From the previous table data we can see that the realized gross fixed capital formation by purpose of investment in the manufacturing of wood and wood products is only 0,2%, and in furniture production about 0,7% from the total investments in manufacturing for the analyzed period.

For establishing the economic efficiency of investments with particular importance is their volume and technical structure. In relation to the technical structure the investments in the woodworking industry are divided into constructing actions (building and structures) and investment in machinery and equipment. Investments in the construction section actually represent investment for production halls, administrative buildings, warehouses, various infrastructure facilities etc... Investments in machinery part represent investment in machinery and equipment, means of transport and communications, energy devices and installations, large tools, instruments and apparatus, etc...

Data on the value of investments in fixed assets according to the purpose of investment and technical structure for the manufacturing of wood and wood products and furniture production, as well as for the total woodworking industry, according to the National Classification of Activities are obtained from the State Statistical Office of the Republic of Macedonia. The value of investments given as tangible fixed assets with the following technical structure: buildings and structures and machinery and equipment.

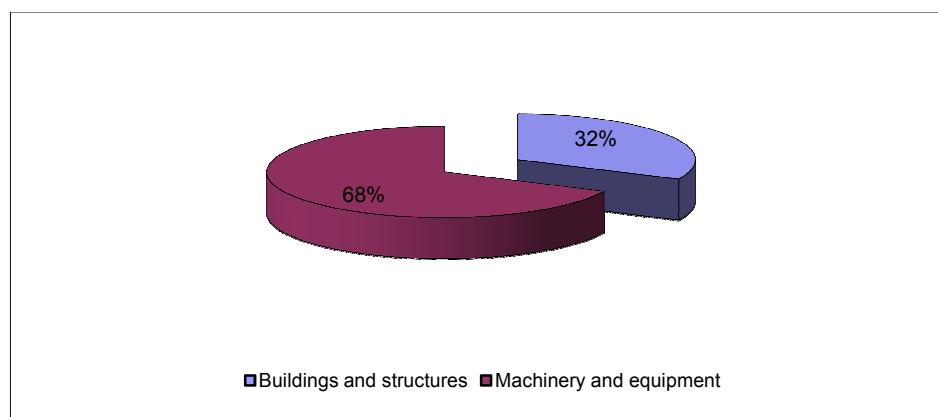
Investments made in the sector according to the technical structure in the period 2007 - 2010 are characterized by fluctuations from year to year (Table 2). The investments in the construction section ranging between 9.2% in 2007 and 42.0% in 2009. The investments made in machinery and equipment ranging from 58.0% in 2009 to 90.8% in 2007. The average participation of investment in buildings is 32.0%, and in machinery and equipment 68.0% of value in the analyzed period.

**Table 2. Technical structure of investments in woodworking industry, for the period 2007 – 2010**

Year	Total (%)	Buildings and structures (%)	Machinery and equipment (%)
2007	100,0	9,2	90,8
2008	100,0	33,0	67,0
2009	100,0	42,0	58,0
2010	100,0	40,0	60,0
<b>Average</b>	<b>100,0</b>	<b>32,0</b>	<b>68,0</b>

Source: Own calculations based on data from the Publications: Gross Fixed Capital Formation of the State Statistical Office of the Republic of Macedonia

An average percentage participation of the technical structure of investment in the woodworking industry for the period 2007 - 2010 is shown in Figure 1.



**Figure 1.** Technical structure of investments in woodworking industry (in average), for the period 2007 - 2010

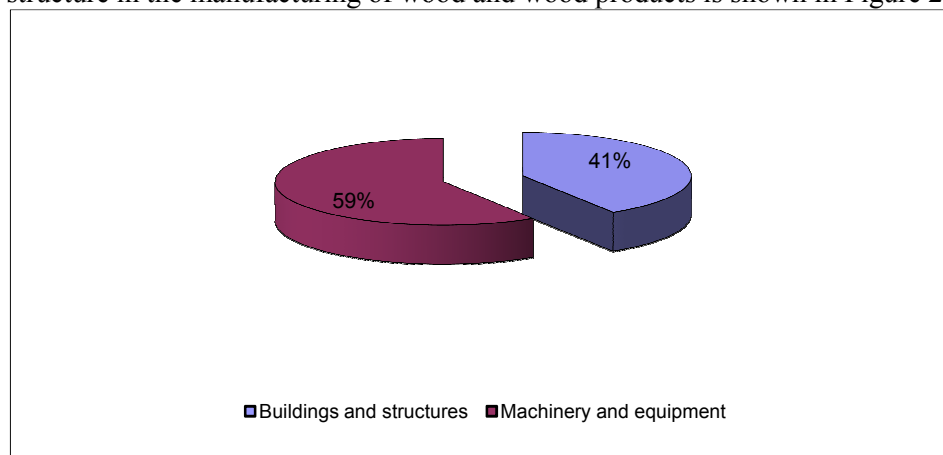
The technical structure of investment in the manufacturing of wood and wood products for the period 2007 - 2010 is given in Table 3. The data in the Table 3 shows that investment in the construction of average amounted to 41.0%, and in the machinery and equipment 59.0%.

**Table 3. Technical structure of investments in manufacturing of wood and wood products, for the period 2007 – 2010**

Year	Total (%)	Buildings and structures (%)	Machinery and equipment (%)
2007	100,0	11,1	88,9
2008	100,0	33,3	66,7
2009	100,0	76,7	23,3
2010	100,0	9,5	90,5
<b>Average</b>	<b>100,0</b>	<b>41,0</b>	<b>59,0</b>

Source: Own calculations based on data from the Publications: Gross Fixed Capital Formation of the State Statistical Office of the Republic of Macedonia

An average percentage participation of investment in its technical structure in the manufacturing of wood and wood products is shown in Figure 2.



**Figure 2. Technical structure of investments in manufacturing of wood and wood products (in average), for the period 2007 - 2010**

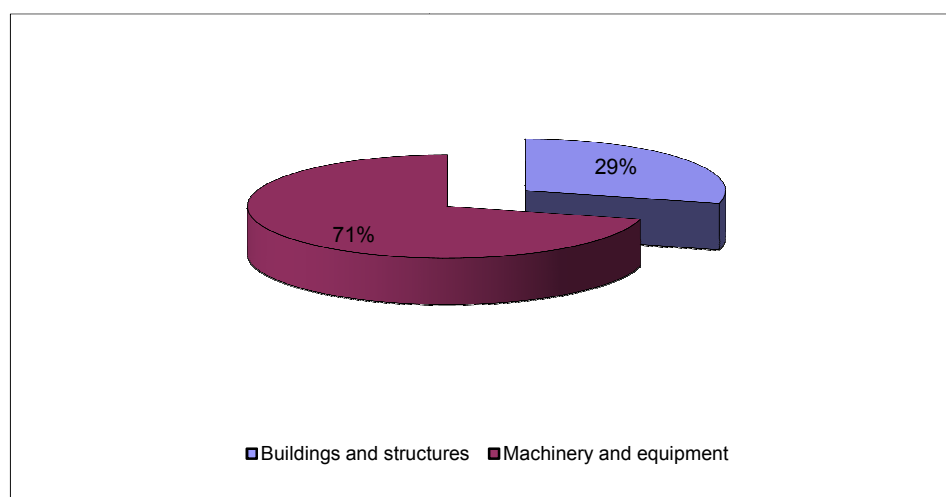
The technical structure of investment in percentage of value in furniture production is given in Table 4. The data in the table show that the average percentage participation of investment in buildings and structures is 29.0%, while investments in machinery and equipment have the largest share even 71.0%.

**Table 4. Technical structure of investments in furniture production, for the period 2007 – 2010**

Year	Total (%)	Buildings and structures (%)	Machinery and equipment (%)
2007	100,0	9,0	91,0
2008	100,0	32,4	67,6
2009	100,0	21,6	78,4
2010	100,0	50,0	50,0
<b>Average</b>	<b>100,0</b>	<b>29,0</b>	<b>71,0</b>

Source: Own calculations based on data from the Publications: Gross Fixed Capital Formation of the State Statistical Office of the Republic of Macedonia

An average percentage participation of investment in its technical structure in the production of furniture is shown in Figure 3.

**Figure 3.** Technical structure of investments in furniture production (in average), for the period 2007 - 2010

In general we could say that in the period 2007 - 2010 investments realized in the woodworking industry, as well as separately in the manufacturing of wood and wood products and furniture production have favorable technical structure. This is due to the fact that more invest in



machinery and equipment, or the introduction of new and modern technologies in order to increase and modernize production.

Investments in fixed assets in the Republic of Macedonia are very small, and their dynamics is extremely unsatisfactory to generate growth for the entire analyzed period. The share of gross investment in fixed assets in GDP is about 19.0%, which is quite small especially considering the low base from which they are due. Such a representation of the investments in fixed assets in previous period indicates the occurrence of disinvestment or maintenance level of the accumulation, or insignificantly higher than that level. Their insufficient volume is determined by the limitations of the sources of their funding, primarily due to the small size of the domestic savings, the high cost of domestic bank loans and unfavorable conditions under which they are approved.

On the other hand the support of the Republic of Macedonia by foreign investors as an additional impetus for growth in the previous period is very small. Numerous reasons for them there were no more interest to finance investment activity. It was due to the low stability of the economic and legal-political system, informing foreign investors about investment opportunities in the Republic of Macedonia, a small market, and lagging behind in the implementation of economic reforms. Therefore foreign direct investment in the Republic of Macedonia were low and ranged from U.S. \$ 9 million in 1995 to U.S. \$ 170 million in 2000.<sup>2</sup>

Foreign direct investment by investment activity for the period 2003 - 2007 in the Republic of Macedonia are derived from publications of the State Statistical Office and presented in Table 5.

From the data in the following table the total foreign direct investment in the Republic of Macedonia in the analyzed period have an upward trend with an average annual rate of 42.3%. Average for the same period was invested U.S. \$ 203,548 million.

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<sup>2</sup> Станкевиќ, М.: Анализа на некои аспекти од развојот на дрвната индустрија во услови на транзиција - состојби, проблеми, перспективи, докторска дисертација, Шумарски факултет, Скопје, 2007, стр. 81

**Table 5. Foreign direct investment by investment activity, for the period 2003 – 2007**

<b>Year</b>	<b>Total (in 000 US\$)</b>	<b>Manufacturing (in 000 US\$)</b>
2003	80643	35936
2004	139460	38586
2005	116168	53989
2006	350665	50498
2007	330802	72987
<b>Average</b>	<b>203548</b>	<b>50399</b>
<b>Average (%)</b>	<b>100,0</b>	<b>25,0</b>
<b>AAR</b>	<b>42,3</b>	<b>19,4</b>

Source: State Statistical Office of the Republic Macedonia, Publication: Foreign Direct Investments in the R. of Macedonia, 2003 - 2007

Foreign direct investments in the manufacturing also tend to increase at an average annual rate of 19.4%. However the participation of foreign direct investment in the manufacturing is about 25.0% of total foreign direct investment in the Republic of Macedonia for the given period. An average during the period 2003 - 2007 in the manufacturing were invested only U.S. \$ 50,399 million.

Considering the above data in the previous analysis of foreign direct investment we can say that in the Republic of Macedonia in the analyzed period is going disinvestment. The disinvestment is involvement of funds from depreciation, so that lags the simple reproduction of the basic production funds of the enterprises, branches and activities. These investments do not increase the national wealth, but make a different allocation of funds between individual branches and activities, respectively areas in a country.

Having regard the small participation of the investment in the woodworking industry in relation of total investment in the manufacturing of the Republic of Macedonia and the disinvestment level of the industry as a central activity, it can be said that the foreign direct investment in the woodworking industry is low and without some significant results.

## CONCLUSIONS

From the previous analysis of the data on investments in the woodworking industry, respectively the manufacturing of wood and wood products and furniture production in aspect of gross fixed capital formation by purpose of investment and the technical structure of investment for the period 2007 - 2010, and foreign direct investment by investment activity in the period 2003 - 2007 can be concluded that:

Realized investments in the manufacturing during the period 2007 - 2010 have a tendency to decrease with an average annual rate of -0.2%. This trend follows and investments in the production of furniture with an average annual rate of -1.5%, as opposed to the manufacturing of wood and wood products where gross fixed capital formation by purpose of investment showed very high growth rate of 32,6% in the analyzed period.

An average annual for the given period investments made in the manufacturing of wood and wood products is only 0.2%, and in the furniture production about 0.7% compared of total gross fixed capital formation by purpose of investments in the manufacturing of the Republic of Macedonia.

The technical structure of the total investment in the woodworking industry for the period 2007 - 2010 is favorable. This is due to the fact that investment in construction (buildings and structures) is represented with 32.0% on average, and investment in machinery and equipment with 68.0% in the analyzed period.

The technical structure of investment in the manufacturing of wood and wood products is also favorable. The average participation of the investment in the construction is 41.0% and investment in machinery and equipment 59.0% for the same period.

Favorable technical structure of investment is characteristic for furniture production for the period 2007 to 2010. The average participation of investment in buildings and structures is 29.0%, and in machinery and equipment 71.0%.

According to previous investments made in the sector, as well as separately in the manufacturing of wood and wood products and furniture production in the period 2007 - 2010 has the necessary technical structure, or more investing in the new machinery and equipment in order to improve the existing production.

The participation of foreign direct investment in the manufacturing is only 25.0% of total foreign direct investment in the Republic of Macedonia for the period 2003 - 2007. Average for the same period in the manufacturing was invested about U.S. \$ 50,399 million.

Small participation of investment in woodworking industry in relation to the total investment in manufacturing of the Republic of Macedonia and the disinvestment in the industry at all requires investment in the sector to be with low level and without some noticeable results for the analyzed period.

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**Professional paper**

**Aleksandra LOZANOSKA<sup>\*)</sup>**

**EUROPEAN UNION LABOUR MARKET  
CHALLENGES AND STRUCTURAL REFORMS  
AFTER 2008 GLOBAL FINANCIAL CRISIS**

**Abstract**

The paper addresses the challenges and structural reforms of the European Union labour market after 2008 global financial crisis. The challenges of the labour market derive from the decline of the number of employees and employment rates, as well as from the increase of the unemployment in EU-27 and its member states. The employment rate decreased from 65,9% (2008) to 64,2% (2010), while the unemployment rate increased significantly from 7,1% to 9,6% respectively.

These changes made numerous challenges on the labour market which are related with the nonflexible wages in the EU, such as minimal wages, central determination of the wages, restrictive legal and institutional limits etc. The immobility of the workers among EU member states, as well as the decrease of the labour productivity, which is result of old and nonflexible industrial structure, are also a big challenges on the EU labour market.

This implies needs for structural reforms on the EU labour market. They consist of few very important reforms such as: policies for activation and help during the unemployment, benefices for the unemployed persons, protection at work, trainings and lifelong learning, hiring tax incentives and child care facilities. The importance of the structural reforms is identified as essential, because only with efficient realization of these reforms the EU labor market will be shifted up, the employment will be maintained sustainable and the unemployment will decrease.

**Keywords:** labor market, employment, unemployment, labour market policy, structural reforms.

**JEL classification:** J21; J08.

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## **Introduction**

2008 global financial crisis has quickly spread from its origin in the United States to the global economy, including the European Union, resulting in collapsed aggregate demand and freezing of credit channels, and subsequently, the worst global downturn since World War II. Consequently, millions of workers around the globe, especially in the European Union, have been laid off, while the lucky ones that held the jobs experienced cuts of wages, working hours and other benefits. These changes have caused continuous rise of the unemployment rates, which will remain relatively high in forthcoming years, unless the economies recover. Therefore, the weakness of the labour market will remain a key challenge for governments in coming years, particularly referring to the vulnerable groups.

This paper analyzes the implications of the 2008 global financial crisis on the European Union labour market, as well as derived challenges and undertaken structural reforms. Therefore, the analysis starts with the employment and unemployment changes in the European Union as a whole (EU-27), as well as in particular member states. Identifying the challenges imposed by the global financial crisis will determine the areas in which should be acted, i.e. determine the structural reforms which are necessary to maintain sustainability of employment and decrease of unemployment.

The analyses is referring to the period from 2000-2010 on the level of the European Union as a whole, as well as in the particular member states. The observation of the employment and unemployment, as well as of the changes and reforms was done using data from Eurostat, numerous documents, strategies and programs of the European Union-27 and the member states, which are regulating the labour market.

## **1. EMPLOYMENT AND UNEMPLOYMENT IN THE EU MEMBER STATES**

The employment in the European Union can be seen as structural and as short term indicator. The structural indicator is measured with the labour force supply and demand balance and provides the perception of the structure of the labour market and the economic system, as well as of the employment quality. The second, i.e. the short term indicator refers to the business cycle in the European Union.

The employment in the European Union was characterized with sustainability and trend of increase, up until the appearance of the global

financial crisis in 2008. After certain period of sustainable economic growth and the existence of conditions suitable for creation of new jobs, the situation on the labour market of the European Union, in the second half of 2008 has significantly changed. It can be also seen from the data for the employment rates, as a participation of the employees in the total working age population (15-64 years of age). In the period from 2000-2010, in the European Union, as well as in the particular member states, this indicator shows big changes. The employment rate in EU-27 in 2000 was 62,2% and had a tendency of increase until 2008 (65,9%). In the last two analyzed years this indicator has decreased and its value is 64,6%, i.e., 64,2% (Table 1).

**Table 1 Employment rates of the population 15-64 years old, in the European Union and member states, 2000-2010**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
EU-27	62,2	62,6	62,4	62,6	63,0	63,5	64,5	65,4	65,9	64,6	64,2
Euro zone	61,4	62,1	62,3	62,6	63,1	63,7	64,7	65,6	66,0	64,7	64,2
Belgium	60,5	59,9	59,9	59,6	60,3	61,1	61,0	62,0	62,4	61,6	62,0
Bulgaria	50,4	49,7	50,6	52,5	54,2	55,8	58,6	61,7	64,0	62,6	59,7
Czech Republic	65,0	65,0	65,4	64,7	64,2	64,8	65,3	66,1	66,6	65,4	65,0
Denmark	76,3	76,2	75,9	75,1	75,7	75,9	77,4	77,1	77,9	75,7	73,4
Germany (1)	65,6	65,8	65,4	65,0	65,0	66,0	67,5	69,4	70,7	70,9	71,1
Estonia	60,4	61,0	62,0	62,9	63,0	64,4	68,1	69,4	69,8	63,5	61,0
Ireland	65,2	65,8	65,5	65,5	66,3	67,6	68,7	69,2	67,6	61,8	60,0
Greece	56,5	56,3	57,5	58,7	59,4	60,1	61,0	61,4	61,9	61,2	59,6
Spain (1)	56,3	57,8	58,5	59,8	61,1	63,3	64,8	65,6	64,3	59,8	58,6
France	62,1	62,8	63,0	64,0	63,8	63,7	63,7	64,3	64,9	64,1	64,0
Italy (2)	53,7	54,8	55,5	56,1	57,6	57,6	58,4	58,7	58,7	57,5	56,9
Cyprus	65,7	67,8	68,6	69,2	68,9	68,5	69,6	71,0	70,9	69,9	69,7
Latvia	57,5	58,6	60,4	61,8	62,3	63,3	66,3	68,3	68,6	60,9	59,3
Lithuania	59,1	57,5	59,9	61,1	61,2	62,6	63,6	64,9	64,3	60,1	57,8
Luxembourg	62,7	63,1	63,4	62,2	62,5	63,6	63,6	64,2	63,4	65,2	65,2
Hungary	56,3	56,2	56,2	57,0	56,8	56,9	57,3	57,3	56,7	55,4	55,4
Malta	54,2	54,3	54,4	54,2	54,0	53,9	53,6	54,6	55,3	54,9	56,0
Netherlands (3)	72,9	74,1	74,4	73,6	73,1	73,2	74,3	76,0	77,2	77,0	74,7
Austria (2)	68,5	68,5	68,7	68,9	67,8	68,6	70,2	71,4	72,1	71,6	71,7
Poland	55,0	53,04,0	51,5	51,2	51,7	52,8	54,5	57,0	59,2	59,3	59,3
Portugal	68,4	69,0	68,8	68,1	67,8	67,5	67,9	67,8	38,2	66,3	65,6
Romania (4)	63,0	62,4	57,6	57,6	57,7	57,6	58,8	58,8	59,0	58,6	58,8
Slovenia	62,8	63,8	63,4	62,6	65,3	66,0	66,6	67,8	68,6	67,5	66,2
Slovakia	56,8	56,8	56,8	57,7	57,0	57,7	59,4	60,7	62,3	60,2	58,8
Finland	67,2	68,1	68,1	67,7	67,6	68,4	69,3	70,3	71,1	68,7	68,1
Sweden (1)	73,0	74,0	73,6	72,9	72,1	72,5	73,1	74,2	74,3	72,2	72,7
United Kingdom	71,2	71,4	71,4	71,5	71,7	71,7	71,6	71,5	71,5	69,9	69,5

(1)Break in series in, 2005

(2)Break in series in, 2004

(3)Break in series in, 2010

(4)Break in series in, 2002

Source: Eurostat (online data code: ifsi\_emp\_a)

As for the member states of EU, the biggest fall of the employment rates in 2010 compared to 2008, is characteristic for Latvia (for 9,3) and Estonia (for 8,8 percentage points). Decrease of this indicator is higher than 5 percentage points in Spain, Lithuania and Greece, and more than 3 percentage points in: Bulgaria, Denmark, Finland and Slovakia. Increase of the value of the employment rate is manifested only in Germany, Luxembourg, Malta and Poland.<sup>1</sup>

According the available data about the unemployment in the European Union, in the beginning of the 2000 less than 20 million persons in the EU-27 were unemployed, i.e. a little less than 9% of the total labour force. In 2001 the number of unemployed was increased on 21 million people and was maintained on that level until 2005. Then began a period of decline of this number and until the first three months of 2008 it amounts 16 million unemployed and unemployment rate of 6,7%. With the impact of 2008 global financial crisis it gets to a huge increase of the total number of unemployed persons and of the unemployment rates.<sup>2</sup>

In the analyzed period 2000-2010 according the Eurostat data, the unemployment rate on the level of EU-27 was increased from 8,7% (2000) to 9,6% (2010). It should be noted that this rate was the lowest in 2008 (7,1%), and its rapid increase came in the next period (Table 2).

In 11 EU member states the value of this indicator in 2010 is higher than the one of the EU-27 level and it changes in the interval from 9,7% (France) to 20,1% (Spain). The analyses of the changes in the unemployment rates in particular member states show significant differences. In some of the countries which have joined the European Union in 2004, i.e. 2007, such as Estonia, Latvia, Lithuania, Poland, Slovakia and Bulgaria, in the period before the global financial crisis it can be noted significant and continuous decrease of the unemployment rates. It respectively by countries is: 8,9; 7,7; 12,1; 12,9; 9,8 and 13,9 percentage points.

At the same time after 2008, the unemployment rates almost in every country start to increase, with exception of Germany, Luxembourg, Malta and Austria in which the value of this indicator is declining. From the rest of the countries, with highest increase of the unemployment rate stands out: Ireland (7,4), Spain (8,8), Latvia (11,2), Estonia (11,4) and Lithuania (12 percentage points). It should be emphasized that from 2008 till 2010 Spain was the country with the highest unemployment rate (11,3%, 18,0% and 20,1% respectively by years).

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<sup>1</sup> Source: Eurostat, Employment statistics,  
[http://epp.eurostat.ec.europa.eu/statistics\\_explained/index.php/Employment\\_statistics](http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Employment_statistics)

<sup>2</sup> Eurostat, Unemployment statistics,  
[http://epp.eurostat.ec.europa.eu/statistics\\_explained/index.php/Unemployment\\_statistics](http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Unemployment_statistics)



These changes in the employment and unemployment in the member states of the European Union, as well as on EU-27 level, points out the strength of the impact which was caused by 2008 global financial crisis. At the same time, large number of the countries was faced with a serious increase of the unemployment rate. This brought them to a situation to be incapable to find enough efficient solutions to decrease the unemployment rate, which would reduce the social tensions and the problems in their economies.

**Table 2 Unemployment rates of the population 15-64 years old, in the European Union and member states, 2000-2010**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
<b>EU-27</b>	8,7	8,5	8,9	9,0	9,1	9,0	8,2	7,2	7,1	9,0	9,6
<b>Euro zone</b>	8,5	8,1	8,4	8,8	9,0	9,1	8,5	7,6	7,6	9,6	10,1
Belgium	6,9	6,6	7,5	8,2	8,4	8,5	8,3	7,5	7,0	7,9	8,3
Bulgaria	16,4	19,5	18,2	13,7	12,1	10,1	9,0	6,9	5,6	6,8	10,2
Czech Republic	8,7	8,0	7,3	7,8	8,3	7,9	7,2	5,3	4,4	6,7	7,3
Denmark	4,3	4,5	4,6	5,4	5,5	4,8	3,9	3,8	3,3	6,0	7,4
Germany	7,5	7,6	8,4	9,3	9,8	11,2	10,3	8,7	7,5	7,8	7,1
Estonia	13,6	12,6	10,3	10,0	9,7	7,9	5,9	4,7	5,5	13,8	16,9
Ireland	4,2	3,9	4,5	4,6	4,5	4,4	4,5	4,6	6,3	11,9	13,7
Greece	11,2	10,7	10,3	9,7	10,5	9,9	8,9	8,3	7,7	9,5	12,6
Spain	11,1	10,3	11,1	11,1	10,6	9,2	8,5	8,3	11,3	18,0	20,1
France	9,0	8,3	8,6	9,0	9,3	9,3	9,2	8,4	7,8	9,5	9,7
Italy	10,1	9,1	8,6	8,4	8,0	7,7	6,8	6,1	6,7	7,8	8,4
Cyprus	4,9	3,8	3,6	4,1	4,7	5,3	4,6	4,0	3,6	5,3	6,5
Latvia	13,7	12,9	12,2	10,5	10,4	8,9	6,8	6,0	7,5	17,1	18,7
Lithuania	16,4	16,5	13,5	12,5	11,4	8,3	5,6	4,3	5,8	13,7	17,8
Luxembourg	2,2	1,9	2,6	3,8	5,0	4,6	4,6	4,2	4,9	5,1	4,5
Hungary	6,4	5,7	5,8	5,9	6,1	7,2	7,5	7,4	7,8	10,0	11,2
Malta	6,7	7,6	7,5	7,6	7,4	7,2	7,1	6,4	5,9	7,0	6,8
Netherlands	3,1	2,5	3,1	4,2	5,1	5,3	4,4	3,6	3,1	3,7	4,5
Austria	3,6	3,6	4,2	4,3	4,9	5,2	4,8	4,4	3,8	4,8	4,4
Poland	16,1	18,3	20,0	19,7	19,0	17,8	13,9	9,6	7,1	8,2	9,6
Portugal	4,0	4,1	5,1	6,4	6,7	7,7	7,8	8,1	7,7	9,6	11,0
Romania	7,3	6,8	8,6	7,0	8,1	7,2	7,3	6,4	5,8	6,9	7,3
Slovenia	6,7	6,2	6,3	6,7	6,3	6,5	6,0	4,9	4,4	5,9	7,3
Slovakia	18,8	19,3	18,7	17,6	18,2	16,3	13,4	11,1	9,5	12,0	14,4
Finland	9,8	9,1	9,1	9,0	8,8	8,4	7,7	6,9	6,4	8,2	8,4
Sweden (1)	5,6	5,8	6,0	6,6	7,4	7,7	7,1	6,1	6,2	8,3	8,4
United Kingdom	5,4	5,0	5,1	5,0	4,7	4,8	5,4	5,3	5,6	7,6	7,8

(1) Break in series in, 2001

Source: Eurostat (online data code: une\_rt\_a)

On the European Union level and in the particular member states drastic measures are undertaken in order to solve the problems with the employment and unemployment. But, still there is the fact that all these countries are faced with numerous challenges and structural reforms which should provide more efficient functioning of the labor market.

## **2. THE EUROPEAN UNION LABOUR MARKET CHALLENGES**

The dynamics of employment, the number and proportion of employed persons are strategic economic and social variables. They affect production capacity and consumption constraints. The general employment rate in European Union can be considered as low. In the period 1970-1995 the value of this indicator was decreased from 65% to 60%. In the next period, the European Union has only recovered the initial employment rate. The capacities of European economy prevent creation of higher employment, which results with rise of the unemployment. Therefore, the growth of GDP is due to productivity gains and catching-up, not as a result of more employments. The employment rate evolves in the opposite direction to its complement, the unemployment rate. Here derives the question what underlines such low employment rates compared to unemployment rates? Is it regulations that militate against job creation, or insufficient growth of the European Union?<sup>3</sup>

Salary inflexibility is a significant challenge of the European labour market. The concept of salary flexibility - either upward in response to growth or downward with drops in productivity, or to business, is not accepted by the European Union. Hence, very important moment is the extent to which the salaries in EU are related to the dynamics of productivity. At the same time, high personal taxation rates and social security payments have the effect of raising salaries, especially in less well paid categories, thus limiting employability. In this light, European Commission has been calling for some time on member states to limit social welfare payments in the case of low paid.<sup>4</sup>

The high unemployment rate in the European Union is a result of the existence of a set of restrictive legal and institutional constraints that drive up the real wage. Examples of such constraints are: high minimum-wage laws, centralized wage settings, requirements for extended notification prior to worker dismissal or plant closure (more than 11 months in Italy), generous family leave policies, and extension of the union wages to large number of non-union employees (up to 90% in France). As a result of these and other restrictions on labour market, flexibility is prevailing wages well above the market equilibrium real wage. This implies a persistently high natural rate of unemployment. The reaction of the European governments on this high rate is by instituting active labour market policies. Still, very often these policies worsen the situation, by

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<sup>3</sup> Ferran Brunet Cid and Mar Lipez Rancaño, *Social Policies and Structural Reforms in Europe*, Romanian Journal of European Affairs, vol. 6, no. 4, 2006, p. 18

<sup>4</sup> Ibid, p.19-20

adding more bureaucratic red tape to labour market policies, which is making less likely that the European employers will hire additional workers.<sup>5</sup>

In addition, firms from Western Europe are seeking for more favorable working conditions to invest their capital. Therefore they are allocating the capital outside Europe. In the 1990s, BMW and Daimler-Benz were located in South Carolina and Alabama. Today firms like Volkswagen, Peugeot, Citroen or Opel are moving eastward to Poland, the Czech Republic, Hungary and Slovakia, forcing western trade unions to respond by reluctantly agreeing to relax restrictive work rules in order to retain jobs in the west.<sup>6</sup>

Additional challenge on the European labor market is the labour immobility across national borders. The European workers are characterized with immobility, i.e. they do not migrate to look for a job.<sup>7</sup> Although, the EU policies attempts to facilitate international migration within the Union, linguistic, cultural and even religious differences often impede cross-border labour mobility within the EU. This situation implies the need to undertake additional measures to increase the labour mobility among the separate member states of the European Union. Also, the immobility of the labour force is causing differences of the employment rate in the member states.

One major challenge of the European labour market is its complexity and inflexibility. This market is not the one, nor is composed of 27 markets, because in some of the member states there are also intra-state regional labour markets. This means that all reforms, measures and policies should be made by taking into account the complex system of the European labor market.

Another significant challenge of the labour market in the European Union is the problem of productivity decline, which is basically of structural nature. Bad results derive from the outdated and inflexible industrial structure, which is very slowly adjusting to the pressure of the globalization process and rapid technological changes.<sup>8</sup> The problems with the productivity of the European economy are due to the fact that the European countries mainly are focused on the industries which are based on using low and middle technologies, characterized by descending rates of productivity and declining of investments. At the same time, EU cannot deal with the USA domination in the field of the

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<sup>5</sup> Soper C. John, *European Labor Markets and Structural Reform: Does the Euro Have a Future?*, The Journal of Private Enterprise, Volume 20, number 1, John Carroll University, Fall, 2004, p. 1

<sup>6</sup> Boudette Neal E., *As jobs head East in Europe, power shifts away from unions*, The Wall Street Journal, A1, March 11, 2004

<sup>7</sup> Only 1,6% of Europeans live in a different country to the one in which they were born. OECD (*Society at a Glance*, OECD Social Indicators, Paris, 2011, p. 52)

<sup>8</sup> Denis, C., Mc Morrow K., Röger W. and Veugelers R., *The Lisbon Strategy and the EU's structural productivity problem*, European Economy, Economic Papers (of the Directorate General for Economic and Financial Affairs), No. 221. February, 2005, p. 61

ICT industry because of the low level of participation of this sector in Europe. It additionally burdens the decrease of unemployment, because higher productivity provides possibilities to make bigger profits, and by that, more opportunities to open new jobs in particular companies.

The biggest part of the labor market policies in EU are directed towards increase of the flexibility during the entry and exit in/from employment. Much better results are accomplished by the member countries which have started the reforms on the labour markets earlier, and which are using more active, than passive labour market policies. This provides improvement of the skills and increase of the opportunities for employment of the unemployed persons.

### **3. STRUCTURAL REFORMS IMPLEMENTED IN THE EUROPEAN UNION LABOUR MARKET**

The reforms which are implemented on the European labour market can be divided in two groups. First ones are those undertaken after the global financial crisis in 2008, and the second ones are the structural reforms which are conducting since 2010.

After the crisis in 2008, the reforms were focused on supporting the aggregate demand, employment and income support, in order to reduce social distress caused by the crisis, whilst at the same time on easing transition to new jobs:<sup>9</sup>

- a) Measures encouraging flexible working time arrangements have emerged as a new feature of the policy response to contain the impact of the crisis on employment. Short time working schemes were widely used across the EU to maintain existing jobs. Apart from these schemes, employment and labour demand were supported by significant reductions of employers' social security contributions and labour income taxation.
- b) Significant reform was conducted in the unemployment benefit system which played essential role in income stabilization. Most of the member states have increased the range of persons who are receiving these benefits, including the unemployed with shorter work experience, as well as the young who are looking for job for longer period. At the same time, benefit duration was extended and the replacement rate was raised. Still, all these measures were set as temporary i.e. will be applied as long as the worst consequences of the crisis are overcome.

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<sup>9</sup> European Commission, *Labour Market Developments in Europe*, Directorate-General for Economic and Financial Affairs, , 2011, p. 34

- c) Activation and assistance policies were reinforced in many countries to provide effective services to an increasing number of unemployed and prevent immediate job losses from turning into long-term unemployment. The focus was on enhancing employability of those hit by the crisis, by more efficient job placement mechanism and expanding training and lifelong learning opportunities. The employment was encouraged by determining lower wages for the persons that cannot find employment easily, by providing employment subsidies, as well as job creation schemes.
- d) Many countries members of EU revised the legislation on hiring and firing in order to reduce labour market segmentation and to allow smooth labour reallocation from contracting to expanding sectors.

As the member states registered growth in their economies, the European Council in 2010 called for termination of the previous temporary measures, which were set to outcome the consequences of the global financial crisis and to start long-term structural reforms, in order to stimulate the economic growth and the employment potential. If the previous measures were directed towards maintaining the labor force supply and ease the transition to new jobs i.e. were used in the struggle with the structural unemployment, the new measures should contribute for support of the labour force market dynamics, for facilitation of the labour reallocation, as well as for the reduction of the market segmentation (measures to reduce hiring and dismissal costs).

More significant reforms of the European Union labor market are the following:<sup>10</sup>

- a) *Activation and assistance policies for employment* - large number of the EU member states have created institutional network which should provide more efficient services by: reorganizing the public employment services (Lithuania, Luxembourg, Ireland), decentralizing activation (Lithuania, Luxembourg) and increasing the staff capacity (Spain, Sweden). The work of the public employment services was directed towards better compliance of the labour force supply and demand, taking measures for the specific groups (such as: young, the older and long-term unemployed). Targeted measures were also introduced to keep older persons either employed, by supporting their transition within a firm to jobs with lighter duties, or attached to the labour market (Belgium, Luxembourg). The measures for reintegration were aimed to the persons who lost their jobs in the specific sectors, such as the construction and financial sector (Ireland, Luxembourg). Also,

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<sup>10</sup> Ibid., p. 34-36

measures were taken to bring the disabled back to work (Netherlands, Sweden).

- b) *Unemployment benefits* - these reforms were aimed at encouraging the unemployed to take up work without losing unemployment benefits. These measures very often were targeted to long-term unemployed, who either set-up their own business with low income or take up part-time jobs (Slovakia, Portugal, Germany, Slovenia). A relatively few countries adapted unemployment benefit system to provide either additional income stabilization or to adjust to the circumstances of economic recovery. All these reforms were with short terms, or the benefits were used for short period of time, while the criteria to determine the users of those benefits were stricter (Denmark, Portugal, Slovenia, Italy).
- c) *Job protection* - the measures in this segment were taken by the countries which have rigid job protection system (Spain, Portugal, Greece). Under the pressure of enormous unemployment and strongly segmented labour force market, these reforms were initiated by Spain. The groups that can be hired with opened contracts with reduced severance payments were expanded to include almost all unemployed and vulnerable groups, such as women returning to the labour market after child birth or longer period of inactivity and temporary workers. At the same time, more precisely were clarified and broadened the causes for justified dismissal, which allows economic, technical and organizational reasons to be included. In order to deregulate the temporary contracts, were provided temporary employment agencies. In some countries their activities included the public sector (Greece, Spain), while in others (Finland, Netherlands) restrictions on the extension of the fixed term contracts were loosen up.
- d) *Training and life-long learning* - reforms in this area are related to the improvement of the possibilities for employment, through decrease of the skills mismatch, which are offered and demanded on the labour market, as well as of the lack of skills needed for some unemployed person to find employment. Part of these measures expanded training opportunities, usually to certain target groups, such as the unemployed and young, while some measures encouraged taking up training with financial incentives. Conversely, to reduce costs, some countries restricted financing of training, by making conditional upon subsequent employment or taking an exam. Some measures allow up-skilling of employees, by providing them the right to training at work and taking leave from work for training purposes.

- e) *Hiring tax incentives, child care facilities* - these are number of measures aimed at making hiring for employers and work for employees more attractive. Tax incentives were usually conditional upon new hires of specific and less employable demographic groups (Italy, Greece, Spain and Portugal). These measures were widely used to complement job assistance and activation strategies with the aim to facilitate the transition of the unemployed to work. The other group of measures is related to the ease of the women participation on the labour market, by providing tax incentives on income from work and making childcare facilities more available.

The 2011 Annual Growth Survey emphasized an integrated approach to economic reforms in the European Union that would accompany the recovery and full use of the labour market potential:<sup>11</sup>

- Employment friendly tax and benefit systems (e.g. shift of taxes away from labour, flexible work arrangements and childcare facilities that support labor market participation of second earners, reduction of undeclared labour);
- Pensions reforms (change of the retirement age, early retirement) and life-long learning strategies which will contribute to enhancing the initiatives and potentials for older workers to stay active;
- Unemployment benefit systems and activation policies that reward the unemployed who are going back to work (using these kind of measures should help the government to struggle against the dependence from these benefits and unemployment traps);
- Reforms in the labour legislation aimed for better balance between the security and flexibility.

Based on the previous stated challenges and structural reforms, which are conducted on the European labour market, it can be concluded that this market have great possibilities to move forward. Still, particular member states depending on the existing condition on their labour markets, should take different and additional measures and reforms, and the level of success will depend on the conditions and changes in their own economy.

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<sup>11</sup> Ibid, p. 36

## CONCLUSION

As a consequence of the global financial crisis from 2008, both industrialized and developing countries are experiencing massive adjustments to their labour markets that can be seen from the surging number of unemployed and rising levels of poverty. For these reason, in the European Union, labour market policies and reforms should play a complementary role in responding to the crisis, along with macroeconomic and other policies. The purpose is to maintain labour demand for both job retention and job creation, to improve the employability of the unemployed by better matching the labour supply and demand, and help smooth incomes of job losers.

The EU labour market has started to move forward, but the improvements in particular member states are different. Some countries are moving slowly to pre-crisis employment levels in terms of modest economic activity. In the countries which have faced with external and fiscal imbalances, unemployment is rapidly increasing. For others, the starting conditions before the crisis are reflecting the nature of the labour market adjustment when the recovery has started.

The European Union should aim to develop comprehensive and integrated policy and institutional framework that will enable their more efficient responding to the problems on the labor market. Over the medium and long term this involves the development of the labor market institutions and a broad-based social security system, which acts as an automatic stabilizer during the crisis. The barriers to formalization of the employment need to be reduced to ensure that workers have more opportunities to find decent jobs and be protected by the labour market institutions. Finally, all the reforms and policies should be the outcome of constructive dialogue between the social partners.<sup>12</sup>

At the end it can be concluded that challenges on the European Union labour market and reforms which need to be realized, will have to support reallocation across firms and sectors, with appropriate wage policies. Consequently, in many countries limited public finances after the crisis, will direct labour market policies towards the most vulnerable groups in order to decrease the unemployment.

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<sup>12</sup> Cazes Sandrine, Verick Sher, Heuer Caroline, *Labour market policies in times of crisis*, Employment Sector, Employment Working Paper No. 35, ILO, 2009, Geneva, p. 5



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**Professional paper**

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**COMPLIANCE ASSESMENT OF THE MACEDONIAN  
DEPOSIT INSURANCE SYSTEM WITH  
THE CORE PRINCIPLES FOR EFFECTIVE  
DEPOSIT INSURANCE SYSTEMS**

**Abstract**

The purpose of this research is to evaluate the compliance of the Macedonian deposit insurance system with the Core Principles for Effective Deposit Insurance Systems. The results of the evaluation show that the system fully complies with 11 principles, partially complies with 2 and is non-compliant with 4 principles, while it is not possible to determine compliance with one of the 18 core principles. The deposit insurance system is not compliant with principle 1 – Public policy objectives, principle 7 – Cross border issues, principle 13 – Legal protection and principle 14 – Dealing with parties at fault in a bank failure. The principle 2 – Mitigating moral hazard and the principle 12 – Public awareness have been partially compliant and the principle 10 – Transitioning from a blanket guarantee to a limited coverage deposit insurance system is the one which compliance is not possible to determine. After the evaluation analyses this paper presents recommendation in order to improve the compliance and the efficiency of the deposit insurance system of Republic of Macedonia.

**Keywords:** deposit insurance, compliance, core principles, financial stability, assessment

**JEL classification:** G20

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## **Introduction**

In July 2008, the Basel Committee on Banking Supervision (BCBS) and the International Association of Deposit Insurers (IADI) decided to collaborate to develop an internationally agreed set of core principles for deposit insurance. As a result of that collaboration a consultative document entitled *Core Principles for Effective Deposit Insurance Systems*<sup>1</sup>, was completed in 2009. The document presents 18 Core Principles, categorised in 10 groups.

The Core Principles are reflective of, and designed to be adaptable to, a broad range of country circumstances, settings and structures. The Core Principles are intended as a voluntary framework for effective deposit insurance practices. National authorities are free to put in place supplementary measures that they deem necessary to achieve effective deposit insurance in their jurisdictions.

An assessment of a country's compliance with the Core Principles can be a useful tool for countries that are implementing, reviewing or actively reforming a deposit insurance system (DIS).

This paper presents compliance assessment of the Macedonian deposit insurance system with the Core Principles for Effective Deposit Insurance Systems. All 18 Core principles have been shortly explained and compared with the characteristics of the Macedonian deposit insurance system. The assessment results have been summarized in a compliance table. Several recommendations based on the results have been made.

## **1. CORE PRINCIPLE FOR EFFECTIVE DEPOSIT INSURANCE SYSTEM AND THE MACEDONIAN DEPOSIT INSURANCE SYSTEM**

### **1.1. Preconditions**

A deposit insurance system will be most effective if a number of external elements or preconditions are in place. Although these elements are mostly outside the jurisdiction of the deposit insurance system, they can have a direct effect on the deposit insurer's ability to fulfill its mandate. In choosing to implement a deposit insurance system, a number of interrelated components of the national financial system should be considered: the condition of the

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<sup>1</sup> Basel Committee on Banking Supervision and International Association of Deposit Insurers (2009): *Core Principles for Effective Deposit Insurance Systems*, available at [http://www.iadi.org/cms/secure/docs/JWGD1%20CBRG%20core%20principles\\_18\\_June.pdf](http://www.iadi.org/cms/secure/docs/JWGD1%20CBRG%20core%20principles_18_June.pdf)

economy and banking system; the sound governance of agencies comprising the safety net; whether there is strong prudential regulation and supervision; and whether there is a well-developed legal framework and accounting and disclosure regime. In the proposed methodology for Core Principles compliance assessment it is recommended the review of the precondition to rely on external reports, for example, recent Financial Sector Assessment Programme (FSAP) – or to include assessment team’s members with the necessary experience and skills. If no such reports are available then the assessment should indicate that there is insufficient information available for a complete review of preconditions.<sup>2</sup>

Because the latest FSAP report on Macedonia is from 2003 and doesn’t present the actual situation of the Macedonian financial sector, preconditions’ assessment will not be subject of this research.

## **1.2 Principle 1 – Public policy objectives**

The first step in adopting a deposit insurance system or reforming an existing system is to specify appropriate public policy objectives that it is expected to achieve. These objectives should be formally specified and well integrated into the design of the deposit insurance system. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and protect depositors.

The Macedonian Law on Deposit Insurance Fund does not specify any public policy objectives. Rather, the Article 11 of the Statute of Deposit Insurance Fund Skopje states that: “Subject of operations of the Fund shall be insurance of deposits of physical persons in banks and saving houses in the Republic of Macedonia”<sup>3</sup>.

## **1.3 Principle 2 – Mitigating moral hazard**

Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net. Moral hazard may be mitigated by DIS through limiting coverage, exclusion of certain categories of deposits / depositors and by imposing risk based premium. The mitigation of the moral hazard can also be done by other elements of the financial safety net such as good corporate governance, sound risk management, prudential regulation etc.

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<sup>2</sup> Ibid

<sup>3</sup>Statute on Deposit Insurance Fund Skopje (2003), available at <http://www.fodsk.org.mk/mac/regulativa.asp>

The deposit insurance coverage of Republic of Macedonia is limited to 30.000 EUR by Amendment of the Law on Deposit Insurance Fund from December 2010<sup>4</sup>.

The Law on Deposit Insurance Fund states five categories of deposits which cannot be covered with insurance:

- 1) Deposits of physical persons extended under privileged interest terms;
- 2) Deposits of physical persons owners of over 5% of the voting shares in the bank or the savings house;
- 3) Deposits of members of managing bodies of the bank or the savings house;
- 4) Deposits of family members of direct lineage of 1-st degree of the persons referred to in items 2 and 3, spouses and children;
- 5) Deposits related to transactions used for money laundering if the perpetrator has been convicted and the sentence is effective.

The Deposit Guarantee scheme (DGS) of Republic of Macedonia uses flat rate premium system mechanism.

### **1.4 Principle 3 – Mandate**

It is critical that the mandate selected for a deposit insurer to be clear and formally specified and that there will be consistency between the stated public policy objectives and the powers and responsibilities given to the deposit insurer.

Regarding the mandate, the Macedonian Deposit Insurance Fund (DIF) can be defined as pay-box system. The management of the DIF has authorization for reimbursement, premium rate setting, but has no regulatory or resolution responsibilities. The regulatory and resolution mandate has been assigned to The National Bank of the Republic of Macedonia. The DIF mandate is clearly and formally specified in the Statute of Deposit Insurance Fund Skopje.

### **1.5 Principle 4 – Powers**

A deposit insurer should have all powers necessary to fulfill its mandate and these should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, to set internal operating budgets

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<sup>4</sup> Law on Deposit Insurance Fund, *Official Gazzete of RM*, No. 63/200 – basic version, amendments *Official Gazzete of RM*, No. 29/2002, 43/2003 and 81/2008

and procedures, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly.

The Macedonian DIF has above mentioned powers and they are formally specified with the Law on Deposit Insurance Fund and the Statute of Deposit Insurance Fund Skopje.

### **1.6 Principle 5 – Governance**

The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.<sup>5</sup>

The Macedonian DIF is a legal entity owned by the Republic of Macedonia. Governing bodies of the Fund are the Managing Board and the Director. The Article 31 of the Statute of Deposit Insurance Fund Skopje states: “The Managing Board consists of five members appointed by the Government of Republic of Macedonia, three of which proposed by the Minister of Finance, one proposed by the Governor of the National Bank of Republic of Macedonia and one proposed by the Banking and Insurance Association, that should be an expert in the field of banking and finances and that must not be member of a management body or employed in a bank or savings house.” The instructions from the Statute of Deposit Insurance Fund Skopje should provide operational independence, accountability and protect the Fund’s activities from undue political and industry influence.

### **1.7 Principle 6 – Relationships with other safety-net participants**

A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalised.

The article 17 from the Law on Deposit Insurance Fund specifies the information-sharing process between Deposit Insurance Fund Skopje on one side, and National bank of Republic of Macedonia and Commercial bank, on other side.

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<sup>5</sup> Basel Committee on Banking Supervision and International Association of Deposit Insurers (2009): *Core Principles for Effective Deposit Insurance Systems*, available at [http://www.iadi.org/cms/secure/docs/JWGD1%20CBRG%20core%20principles\\_18\\_June.pdf](http://www.iadi.org/cms/secure/docs/JWGD1%20CBRG%20core%20principles_18_June.pdf)

## **1.8 Principle 7 – Cross-border issues**

Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate. In circumstances where more than one deposit insurer will be responsible for coverage, it is important to determine which deposit insurer or insurers will be responsible for the reimbursement process. The deposit insurance already provided by the home country system should be recognised in the determination of levies and premiums.

The Deposit Insurance Fund Skopje does not have any procedures on this principle. The article 54 of the Banking Law states that the deposits in a foreign bank branch should be insured in the Deposit Insurance Fund of the Republic of Macedonia under the same terms as deposits of the banks having its main office in Republic of Macedonia<sup>6</sup>. The Republic of Macedonia has no experience with international deposit insurance, and no foreign bank's branch operates in Republic of Macedonia.

## **1.9 Principle 8 – Compulsory membership**

Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (eg retail and small business depositors) to avoid adverse selection.<sup>7</sup>

The membership in the Deposit Insurance Fund Skopje is compulsory for all banks and saving houses which operate in Republic of Macedonia.

## **1.10 Principle 9 – Coverage**

Policymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.<sup>8</sup>

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<sup>6</sup> Banking Law, *Official Gazzete of RM* No.67/07, 90/09 and 67/10

<sup>7</sup> Basel Committee on Banking Supervision and International Association of Deposit Insurers (2009): *Core Principles for Effective Deposit Insurance Systems*, available at [http://www.iadi.org/cms/secure/docs/JWGDI%20CBRG%20core%20principles\\_18\\_June.pdf](http://www.iadi.org/cms/secure/docs/JWGDI%20CBRG%20core%20principles_18_June.pdf)

<sup>8</sup> Ibid

The article 17 from the Law on Deposit Insurance Fund specifies deposits which are subject to insurance.

The deposit insurance coverage of Republic of Macedonia is limited to 30.000 EUR by Amendment of the Law on Deposit Insurance Fund from December 2010. Before this amendment the deposit insurance coverage was set at 20.000 EUR. Even than 99% of the eligible deposits were covered with insurance, as Governor of the National Bank of Republic of Macedonia, Petar Gosev stated in an interview in the Kapital magazine from 27.11.08<sup>9</sup>.

### **1.11 Principle 10 – Transitioning from a blanket guarantee to a limited coverage deposit insurance system**

When a country decides to transit from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.

From the establishment of the Deposit Insurance Fund Skopje in January 1997, the insurance coverage of the deposits is limited, so Republic of Macedonia doesn't has experience in transitioning from a blanket guarantee to a limited coverage deposit insurance system.

### **1.12 Principle 11 – Funding**

A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system.<sup>10</sup>

The Deposit Insurance Fund Skoje uses ex-ante funding mechanism. The resources of the Fund are composed of the founding capital, collection of premiums for insurance of deposits of physical persons, collection of entry premiums and revenues from investments. The article 21 of the Statute of

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<sup>9</sup> Гошев, П. (2008): *Депозитите на граѓаните се сигурни во банките!*, Kapital magazine No. 471 from 27.11.2008

<sup>10</sup> Basel Committee on Banking Supervision and International Association of Deposit Insurers (2009): *Core Principles for Effective Deposit Insurance Systems*, available at [http://www.iadi.org/cms/secure/docs/JWGD1%20CBRG%20core%20principles\\_18\\_June.pdf](http://www.iadi.org/cms/secure/docs/JWGD1%20CBRG%20core%20principles_18_June.pdf)



Deposit Insurance Fund Skopje specifies means of additional recourses in case of need. From the establishment of the Deposit Insurance Fund until 30.04.2010, during the 13 years the Fund exists in the Macedonian environment, 9 risk events have occurred among the Fund's members i.e. 4 banks and 5 savings houses. The Deposit Insurance Fund with its' own sources of funds managed to reimburse (up to the total deposits by titulars, within the legal framework) all the savers that showed up at the premises of the paying-banks and that have chosen the way they want to dispose with their own resources from the reimbursement.

### **1.13 Principle 12 – Public awareness**

In order for a deposit insurance system to be effective it is essential that the public is informed on an ongoing basis about the benefits and limitations of the deposit insurance system.

The Statute of Deposit Insurance Fund Skopje with article 15 imposes obligation for banks and savings houses, members in the Fund, to place an announcement about the deposits insured in the Fund and about the level of reimbursement by the Fund on the counter where the payment operations are performed<sup>11</sup>. The Deposit Insurance Fund Skopje has a web site with detailed information and a brochure has been published for public information. But yet, there is no on-going public information campaign with a target group and a dedicated budget.

### **1.14 Principle 13 – Legal protection**

The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits for their decisions and actions taken in “good faith” while discharging their mandates. However, individuals must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be defined in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified.

Neither the legal framework, nor the Statute of Deposit Insurance Fund Skopje provides such legal protection.

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<sup>11</sup> Statute on Deposit Insurance Fund Skopje (2003), available at <http://www.fodsk.org.mk/mac/regulativa.asp>

### **1.15 Principle 14 – Dealing with parties at fault in a bank failure**

A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.<sup>12</sup>

Neither the legal framework, nor the Statute of Deposit Insurance Fund Skopje provides such power.

### **1.16 Principle 15 – Early detection and timely intervention and resolution**

The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well defined criteria by safety-net participants with the operational independence and power to act.

The Deposit Insurance Fund Skopje does not have powers regarding this principle. Operational independence and power to act under this issue has the National Bank of Republic of Macedonia. The banking supervision and regulative are designed in a manner of providing early detection and timely intervention and resolution of financial institutions.

### **1.17 Principle 16 - Effective resolution processes**

Effective failure-resolution processes should: facilitate the ability of the deposit insurer to meet its obligations including reimbursement of depositors promptly and accurately and on an equitable basis; minimise resolution costs and disruption of markets; maximise recoveries on assets; and, reinforce discipline through legal actions in cases of negligence or other wrongdoings. In addition, the deposit insurer or other relevant financial system safety-net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed

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<sup>12</sup> Basel Committee on Banking Supervision and International Association of Deposit Insurers (2009): *Core Principles for Effective Deposit Insurance Systems*, available at [http://www.iadi.org/cms/secure/docs/JWGDI%20CBRG%20core%20principles\\_18\\_June.pdf](http://www.iadi.org/cms/secure/docs/JWGDI%20CBRG%20core%20principles_18_June.pdf)

bank (e.g., providing depositors with continuous access to their funds and maintaining clearing and settlement activities).<sup>13</sup>

The bank's failure-resolution process is specified in the Banking Law. The powers and the obligations of the Deposit Insurance Fund Skopje if such process is initiated are incorporated in articles 159, 161 and 163 of the Banking Law<sup>14</sup>.

### **1.18 Principle 17 - Reimbursing depositors**

The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which a reimbursement may be required and be provided with access to depositor information in advance. Depositors should have a legal right to reimbursement up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, whether any advance or interim payments will be made as well as the applicable coverage limits.

Based on the legal changes from December 2010, the Deposit Insurance Fund Skopje is required to start payout in 20 days from insured case realization, which can be considered as prompt reimbursement.

### **1.19 Principle 18 - Recoveries**

The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.<sup>15</sup>

The Deposit Insurance Fund Skopje has fully recovered the paid means for reimbursement of the depositors from the estate of the failed banks.

### **1.20 Assessment results**

The assessment results of the compliance of the Macedonian deposit insurance scheme with the Core Principles for Deposit Insurance Systems are summarized in the table below.

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<sup>13</sup> Ibid

<sup>14</sup> Banking Law, *Official Gazette of RM* No.67/07, 90/09 and 67/10

<sup>15</sup> Basel Committee on Banking Supervision and International Association of Deposit Insurers (2009): *Core Principles for Effective Deposit Insurance Systems*, available at [http://www.iadi.org/cms/secure/docs/JWGD1%20CBRG%20core%20principles\\_18\\_June.pdf](http://www.iadi.org/cms/secure/docs/JWGD1%20CBRG%20core%20principles_18_June.pdf)

**Table 1: Compliance assessment of the Macedonian deposit insurance system with the Core Principles for Effective Deposit Insurance Systems**

<b>Principle</b>	<b>Name</b>	<b>Compliance/Non-compliance</b>
Principle 1	Public policy objectives	no
Principle 2	Mitigating moral hazard	not fully
Principle 3	Mandate	yes
Principle 4	Powers	yes
Principle 5	Governance	yes
Principle 6	Relationships with other safety-net participants	yes
Principle 7	Cross-border issues	no
Principle 8	Compulsory membership	yes
Principle 9	Coverage	yes
Principle 10	Transitioning from a blanket guarantee to a limited coverage deposit insurance system	n/a
Principle 11	Funding	yes
Principle 12	Public awareness	not fully
Principle 13	Legal protection	no
Principle 14	Dealing with parties at fault in a bank failure	no
Principle 15	Early detection and timely intervention and resolution	yes
Principle 16	Effective resolution processes	yes
Principle 17	Reimbursing depositors	yes
Principle 18	Recoveries	yes

## CONCLUSION

The deposit insurance system of Republic of Macedonia fully or partially complies with 13 out of 18 Core Principles for Effective Deposit Insurance Systems. The deposit insurance system fully complies with 11 principles, partially complies with 2 and is non-compliant with 4 principles, while it is not possible to determine compliance with one of the 18 core principles.

In order of improving the level of compliance of the Deposit Insurance System of Republic of Macedonia several recommendations can be made:

- a public policy objectives of the deposit insurance should be formally specified;
- risk-based premium funding mechanism should be introduced;
- A possibility of international deposit insurance should be predicted, and the rights and obligations of different deposit insurers in such case should be formally specified;
- in order to increase public awareness an on-going public information campaign should be developed;
- The DIF staff should be provided with a legal protection for decision taken in good faith;
- The Deposit Insurance Fund Skopje should be provided with a power to seek legal redress against parties at fault in a bank failure.

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1. Banking Law, *Official Gazette of RM* No.67/07, 90/09 and 67/10
2. Basel Committee on Banking Supervision and International Association of Deposit Insurers (2009): *Core Principles for Effective Deposit Insurance Systems*, available at [http://www.iadi.org/cms/secure/docs/JWGDI%20CBRG%20core%20principles\\_18\\_June.pdf](http://www.iadi.org/cms/secure/docs/JWGDI%20CBRG%20core%20principles_18_June.pdf)
3. Basel Committee on Banking Supervision and International Association of Deposit Insurers (2010): *Core Principles for Effective Deposit Insurance Systems*, available at

<http://www.bis.org/publ/bcbs182.pdf>

4. Гошев, П. (2008): *Депозитите на граѓаните се сигурни во банките!*, Kapital magazine No. 471 from 27.11.2008
5. Law on Deposit Insurance Fund, *Official Gazzete of RM*, No. 63/200 – basic version, amendments *Official Gazzete of RM*, No. 29/2002, 43/2003 and 81/2008
6. Statute on Deposit Insurance Fund Skopje (2003), available at <http://www.fodsk.org.mk/mac/regulativa.asp>

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**BORROWING AS A FORM OF FINANCING LOCAL  
GOVERNMENT IN REPUBLIC OF MACEDONIA**

**Abstract**

Financing the local government in Republic of Macedonia can be achieved through various forms of financing sources. According to the newly made legal framework local governments can be financed through:

- taxes ( property tax, inheritance and gift tax, income tax, value added tax and sales tax on real estate)
- local charges
- local fees
- property revenues
- transfers from central government
- borrowing

It is primary goal for every unit of local government to try and provide all its necessary finance from revenues, taxes, local fees and local charges i.e. from own sources. But not always the local government can cover all its expenditures with own sources, especially when it comes to capital investment which also concern the higher level of governance and are too expensive and timely spread for the local governance to finance them by itself. For this kind of financing local governments can't turn only to their own resources, they will have to find other sources in the transfers from central government and borrowing. Transfers from central government are usually used for target capital projects that are part of the central government strategy. But what about the capital projects of the local government, or simply what if the local governments in Republic of Macedonia can't cover their expenses with their own sources? That is where borrowing as a possibility of local governments for financing from external sources comes in. This article elaborates borrowing as a possibility of the local governments of Macedonia to gain financial assets necessary for their development or day to day provision of public goods and services for the municipality residents.

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**Key words:** Borrowing, municipality, local government, state loans, bank loans, municipality bonds.

**JEL classification number:** H74 (State and Local Borrowing)

### Introduction

Municipal funding and fund raising for continuous operation can be performed through borrowing. Borrowing represents a form that usually finances capital expenditure of municipal borrowing and is not convenient to use as a form that would cover the ongoing costs to municipalities. This kind of borrowing is unsuitable as a reason for creating even greater budget deficits in municipalities previously due to an increase of funds to be returned and the interest which represents an additional expense. The borrowed funds invested in current expenditures of the municipalities do not generate income and therefore are not desirable investment. For these reasons most often there are certain limitations in the forms of borrowing or the size and purpose of the money the municipalities can borrow. However opportunities for municipal borrowing mainly include:

- State loans
- Bank loans
- Issuance of bonds

### 1. STATE LOANS

Borrowing from the state *is done*, according to previously determined budget plan following a specific legal framework. When planning the budgets of municipalities there is a possibility if financial assets are needed for capital expenditures a loan from the state may be requested. In this case it should be noted that borrowing from the state differs from financial transfers granted by the same. Financial transfers are calculated in the plan budget of the municipalities and if there is a need for additional funds municipalities can take a loan from the state. Borrowing from the state has certain legal regulations and limits that must be followed. While it is different depending on the legal system of certain countries and the legal framework for municipal borrowing still have to follow certain rules that usually apply to the loan size and purpose of use of funds. Again, it is imperative that funds borrowed from the state to be used for capital investment; otherwise it can deepen the budget deficit to municipalities. Loan from the state may require all municipalities if the law is not otherwise regulated, but preference is given to those municipalities whose purpose loan is in close correspondence with the national strategy for development and growth



of the same. In fact, loans from the state are able to be structured so to be used strictly for the particular purpose which is consistent with the strategy for sustainable development. Perhaps the method of borrowing the funds from the state is more desirable for municipalities that have no collateral or security that will interest private banks, or those municipalities that have high incomes and financial capacity and can easily get a loan from a private institution. In this case the state should help by providing loans with low interest rates to stimulate the financial growth of the municipalities. The state should not offer preferential rate of borrowing for all municipalities because in that case you can perform the phenomenon of **crowding out** the private sector. Private financial institutions will be able to maintain the competitiveness of the country and forced interest rates will be squeezed out of the capital market for municipalities. Therefore the state should set a good legal framework that would prevent the occurrence of this phenomenon and also would not discourage and financially stronger municipalities to borrow from it.

## 2. BANK LOANS

Bank loans represent another alternative to borrowing money that is available to municipalities. Borrowing in the private sector for the municipalities is also subject to certain laws and restrictions so that it doesn't lead to creating a budget deficit. The purpose of the loan and credit of the municipality are the most important segments in determining the possibility of lending to municipalities with commercial banks. Restrictions are commonly placed on the municipal segment of borrowing in the private sector relating to:

- The interest rate
- The period of borrowing
- The value of collateral that they can offer
- The purpose of utilizing the collected credit

Limits on borrowing practice it is in all countries where it is legally allowed municipalities to borrow in the private sector. Their placement should ensure greater financial stability and zealously managing their debt so that a greater budget deficit does not occur. In practice municipalities can borrow at<sup>1</sup>:

- Domestic and foreign banks, commercial banks
- Specialized banks for local government financing
- Loan Funds - Local Development Funds

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<sup>1</sup> Aleksandra Maksimovska Veljanovski, *Fiscal decentralization and financing local government in Republic of Macedonia*, Skopje 2007, pg.

Macedonian municipal borrowing is regulated by the *Law on Local Self-Government*. Municipalities can borrow in domestic banks in domestic currency and foreign currency in the respective country in which is charged with prior approval from the Ministry of Finance of the Republic of Macedonia. Municipal borrowing by law must submit proper insurance and that insurance can't be a property used to perform public service or that provides public services. Borrowing can be short and long term. Short municipality loans can be borrowed only domestically. The purpose of short-term debt is determined mainly to cover the current shortage of funds but not if they are returned with another debt or to recover certain penalties and interest. The law states and limits in terms of borrowed funds for municipalities can't borrow short term loans greater than 20% of last year's revenues<sup>2</sup>. Despite short-term municipal borrowing, they are allowed to borrow long term, but while debt charge of equal or decreasing annuities. Long-term borrowing is limited and must not exceed 15% of total revenue that the municipality had accomplished the previous period. Long-term borrowing is approved by the Municipal Council<sup>3</sup>.

### 3. MUNICIPAL BONDS

Municipalities can come up with funds through the issuance of municipal bonds. Bonds represent securities that the issuer takes the obligation to pay the holder of the bond amount specified in the same plus appropriate interest on the maturity date of the bond. Through this type of securities municipalities fail to collect significant amounts of funds to finance current needs or some capital investments. Municipal bonds are attractive to investors because they typically have a higher rate of return than government bonds and thus offering a small amount of risk. In some cases municipal bonds may have higher interest rate than that given by banks for deposits. Municipalities can come up with funds through the issuance of municipal bonds. Bonds represent securities that the issuer takes the obligation to pay the holder of the bond amount specified in the same plus appropriate interest on the maturity date of the bond. Through this type of securities municipalities manage to collect significant amounts of funds to finance current needs or some capital investments. Municipal bonds are attractive to investors because they typically have a higher rate of return than government bonds and thus offering a small amount of risk. In some cases municipal bonds may have higher interest rate than that given by banks for deposits. This will cause a greater investment in municipal bonds contributing to the greater development of the municipalities in its entirety because of a greater amount of funds which in this way through municipal bonds would be

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<sup>2</sup> *Law for public debt*, Official journal of Republic of Macedonia, Number 62/05 and 88/08

<sup>3</sup> *ibidem*

available to them. The only requirement to be met and who also is a limitation on the use of municipal bonds is a developed financial market. Without a sufficiently developed financial market municipal bonds would not have the necessary liquidity and it would make them less interesting for investors. Without a properly developed financial market the ability to raise capital through this instrument would be drastically reduced.

Depending on the benefits to be gained by issuing a bond, there are several types of municipal bonds. If the funds that are received from the bonds that are used for providing a public good or service which will benefit the municipality then that is a **general bond**. Commonly used for investments such as: public parks, streets and bridges, public safety, public buildings etc. This type of bonds is secured with local revenues. **Revenue municipal bonds** are used exclusively for projects that generate income. These bonds are returned just by generating income from investments such as water systems, highways, public parks etc. If funds generated from this type of income is not sufficient to repay municipal bonds then tax funds are used. Often municipalities insure these bonds with additional tax revenues, this makes them more attractive for the investors. There are **insured municipal bonds** in which a particular insurance company guarantees payment of the bond if the municipality can't. Municipal bonds do not only have to list in domestic market. There are bonds that are denominated in a currency other than the country of origin called **Euro-bonds**. Municipal bonds may also differ by interest (variable or mobile) and by certain options which they have, as early payment or withdrawal of the bond from the market etc.

Benefits of issuing municipal bonds can be seen in the following<sup>4</sup>:

- Mobilization of resources
- implementation of planned development projects
- acceleration of local and regional economic growth
- gaining greater financial independence from central government
- improve local economic conditions through greater investment, employment, increase quality of life of citizens

Besides the benefits to municipalities the investors acquire certain uses in investing in municipal bonds, i.e.:

- obtaining yield
- Development of capital market and the opportunity for enhanced diversification of portfolios

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<sup>4</sup> Ministry of Finance, Republic of Macedonia, *Guide for issuing municipality bonds*, February 2011, pg 6

- return on these bonds is exempt from personal income tax
- Investment and development in the environment in which they live in.

Macedonian municipalities can issue bonds, after approval by the Ministry of Finance. Bonds under the law may be issued by public or private offering.

The private offer is a limited offer in which bonds are offered to the investor by a direct route. Issuance of municipal bonds should be for a particular purpose, and municipalities in Macedonia are allowed to issue bonds for one respective purpose annually. Issuance of bonds through a private offering by investors is composed of several steps<sup>5</sup>:

1. Decision to issue bonds through a private offering - this decision is made by the municipal council
2. Finding an interested investor - an investor in case of a private offering of municipal bonds may be the only institutional investor, i.e. bank, insurance company, investment fund and pension fund.
3. Request approval from the Commission for securities issuance of bonds through a private offering
4. Decision on the request for authorization to issue bonds through a private offering
5. Issuance of bonds registered and for the realization of the private offering of bonds

Issuance of bonds by public bid is a public call for subscription and purchase of bonds. Issuance of bonds by public bid by investors is composed of several steps<sup>6</sup>:

1. Decision to issue bonds through public offering - this decision is made by the municipal council
2. Selection of external consultants and contract with the agent for issuance of bonds - to be conducted a public offering of bonds by the municipality they need to hire a bank or brokerage company with a dual function as legal entities that would have implemented the public offer
3. Request approval from the The Securities and Exchange Commission of the Republic of Macedonia for issuance of bonds by public bid
4. Issuing a decision approving the application for issuance of bonds

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<sup>5</sup> Ministry of Finance, Republic of Macedonia, *Guide for issuing municipality bonds*, February 2011, pg 8

<sup>6</sup> Ministry of Finance, Republic of Macedonia, *Guide for issuing municipality bonds*, February 2011, pg 10

5. Initiation of enrollment and payment of the bonds - government within 30 days after receiving the decision of the Securities and Exchange Commission of the Republic of Macedonia are obliged to hold a public bid or they need to notify the Commission if there is some change of conditions in the public offer
6. Advertising the public offer
7. Procedure for registration of the bonds - this procedure is performed in the premises of the municipality and is considered successfully completed if the deadline for implementation of emissions at least 60% of the offered bonds are paid. Following the procedure of registration of municipal bonds has an obligation to register securities in an authorized depository for bonds. Bonds cannot be subject to trading on the secondary market until they are registered in the Official depository of securities.
8. Reporting the outcome of the public offering - the municipalities shall, within 15 days after the offer, notify the Securities and Exchange Commission of the Republic of Macedonia in connection with the performance of supply, i.e. the percentage of realization of the offer.
9. Registration of bonds in the authorized depository - the registration of bonds by the name of the holder of the bond is made in the form of electronic record.

Bonds to be attractive on the market and be able to attract more investors are necessary to have an appropriate credit rating. Law on issuing municipal bonds provides credit rating as mandatory for all municipalities that want to get a loan by issuing bonds. Credit ratings should be determined by international agencies and as such contribute to attracting not only domestic but also foreign investors. The credit rating actually shows the potential for loan power by municipalities or their creditworthiness. Most credit ratings are awarded to municipalities that have strong financial capacity, stable cash flows and are creditworthy. The municipalities that have do not have strong financial capacities are already in debt and cash flows are not constant receive lower credit ratings. Normally there are many more factors that are taken into account when calculating and evaluating the credit rating of a municipality, so that investors have a clearer picture on what kind of securities invested. Credit rating in the Republic of Macedonia is assigned to 5 municipalities by international credit rating agency Moody's, respectively:

- Gevgelija B1
- Gostivar B1
- Kumanovo B1

- Stip B1
- Ilinden B2

Scores B1 or B2 for credit rating of municipalities indicate low credit rating municipalities whose securities are highly speculative and are even found in the field of non investable securities. This indicator is not surprising given that government bonds have credit ratings of BB rated by Standard & Poor's. Because of the high possibility of speculation of this type of securities the number of international investors who invest in them (such as large pension funds legally are not allowed to investment in securities with credit ratings below BBB-) decreases. As reasons for the low credit rating of municipalities in Macedonia Moody's lists:

1. The process of decentralization and adjustment of municipal
2. Weak financial capacities
3. Over-dependence on central government
4. Inflexible budget
5. Modest level of management
6. Lack of adequate staff
7. Requirements for infrastructure solutions, etc.

Until these basic conditions for the municipalities are met, especially in view of the growth of the financial capacity of the municipalities, they will retain this credit rating. In case they are obliged by issuing bonds or taking loans from a financial institution, the credit rating may fall, making them more unwanted by the investors. Because of that the need points to strengthening the financial capacity of the municipalities and to improve their financial condition in general before switching to the issuance of bonds. The need of funds provided through the issuance of bonds or borrowing can cost municipalities more than the interest rate (cost of capital). Municipalities may be falling into negative spiral of borrowing and reduced credit rating, making their normal operation and perform tasks virtually impossible. Yet despite the borrowing and strengthening the financial capacity, they should not forget the other drawbacks that can also pose a problem for getting more solid credit rating, and thus attracting more investors.

## **CONCLUSION**

Borrowing as a form of acquiring financial assets by the municipalities can be perceived as necessary source of external financing. Especially when most of the local governments in Republic of Macedonia lean towards it when own resources are not enough for covering expenditures or capital investment. Borrowing for capital investing is justified, because of the revenue it will provide in the future making the loan easier to return without more pressure on the cash flow. In extreme cases it can even use the loan to cover some grave budget deficit. But never the less local governments must not relay on borrowing as a tool for covering day to day expenditures for providing public goods and services and other administrative costs. This will ultimately lead to creating a negative spiral for the municipalities therefore making them less creditworthy. With weak financial capacity, lack of human resources in financial management and small revenue raising possibilities municipalities in Republic of Macedonia don't have the luxury to become less creditworthy. Their credit rating is already at speculative level so that leaves them no further possibility of delaying the necessary changes that have to occur in almost every part of local governance. Hence the reasoned mentioned above borrowing by the local government in any form should be used only for investing in capital projects i.e. projects that can generate income which will then be used for returning the money borrowed.

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