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MASTER THESIS

THE EFFECTS OF FOREIGN DIRECT INVESTMENTS ON EMPLOYMENT IN MACEDONIA

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INTRODUCTION

One of the key characteristics of developing countries is the low per-capita income as well as low human development indicators. Large number of developing countries achieves rates of economic growth per capita that are lower compared to the ones of the developed countries. While the most cited reasons for that are weak institutions and industrial policies; some economists are citing the lack of national development strategy, lack of balanced budget, moderate interest rates, and competitive exchange rates. Another reason is that the increase in wages is not following the growth in productivity, which relates to the huge supply of labor in these countries (Bresser Pereira, 2010, p. 2). In their efforts to overcome these challenges, the developing countries are increasingly looking at the foreign direct investment (hereinafter: FDI) as a major catalyst of economic development and complementing source to the national income and employment growth.

The expectations that FDI will solve the most acute problems of the developing countries had led to tough competition among these countries in attracting FDI. Yet, the question about the benefits from FDI towards development of the host country and the risks that come with FDI is still valid. The next question is what type of policies host governments should apply in order to get the benefits and avoid risks related to FDI. Is it sufficient that the host government put in place all the fundamentals, like sound macroeconomic policies that are investment-friendly and reliable legal system, or the government should take a more pro-active role in attracting FDI and improving their use in the country development? In that line, one of the crucial steps for maximizing the benefits of the FDI for the country development is the choice of right policies and creation of the investment-friendly environment.

In their efforts to attract and retain FDI, host countries are using a variety of incentives, which is not an exclusive approach of the developing countries only. Governments are offering these incentives to convince potential investors to bring their investment in these countries and neutralize the competing opportunities offered by other countries. Furthermore, once FDI occurs in their countries, the governments are offering incentives in order to encourage the foreign investors to deepen the linkages with the local stakeholders and thus stimulate positive spillover effects through hiring local employees, procuring goods and services from local suppliers, or providing training of the hired workforce. However, these incentives can be costly, and the cost-benefit analysis of these measures can be challenging, not only because both, the costs and benefits, can be dispersed within the host country and beyond its border, but due to the level of transparency and data availability in general, as well. The incentives can be expressed in relation to the government revenues, or the value of the investment, or the cost per job created. For example, as presented at the Eight Columbia International Investment Conference on Investment Incentives, held in November 2013, the average incentive value per job created

in the Czech Republic is \$67,088, while in the U.S. it can be from \$34,440 in Mississippi up to \$223,000 in Louisiana (Investment Consulting Associates, 2013). In Macedonia, according to some estimates, that average amount of incentives per job created by the FDI amounts to \$23,500 (Zdravkovska, 2016, p. 18). The offered incentives can be in different forms; the most prevalent being the tax exemptions, capital grants, grants for hiring and training employees, or infrastructure.

However, for attracting FDI, not only these various types of incentives are important, but also the good general economic fundamentals, presence of infrastructure and qualified workforce, and so forth. Kunčič and Svetličič (2011), in their study on the attitudes and beliefs of the people involved in the FDI industry, made distinction between two major groups: one that emphasizes the presence of good economic fundamentals and local measures, and other, giving preference to the financial measures (fiscal incentives and subsidies); analogous to the distinction between the Keynesians and the neoclassicists in the economic theory. All these aspects describe the complexity and difficulty of the environment where the developing countries should design a policy for attracting FDI that would work.

The benefits from FDI to these economies are not only related to the transfer of newer technologies and better quality and cost control, but to transferring more sophisticated techniques in management and marketing, as well as human capital development. However, the spillover effects will not occur by default. Not all countries enjoy the benefits of the FDI equally. While some countries enjoy positive effects from FDI, which is reflected in the accelerated growth of their economies, there are countries where FDI have made more damage than benefit to their economies.

In their comparative study on the FDI spillover effects in ten comparable transition countries, Damijan et al (2003a, p. 19) make a distinction between direct FDI effects from the parent company to the local affiliate, and the horizontal and vertical spillover effects from the foreign affiliate to the domestic local company. Their findings indicate that, in terms of the direct FDI effects, they are significant in five out of ten examined countries, and provide the biggest impact on the productivity of local firms. On the other hand, the vertical FDI spillovers have bigger importance than horizontal ones on the company's productivity. Blomström et al. (in Blomström and Kokko, 2001, p. 8) find that the overall development level of the host country is a factor that influences the spillover effects, given that the spillovers are more frequently happening in the middle-income countries than in the poorest ones. Balasubramanyam (2001, p. 9) points that, for a host country to benefit from FDI as an instrument for development, it should have a stable economic climate, developed infrastructure capacities and certain level of human capital.

There is distinction between FDI made in developed countries and those that flow in developing countries. In general, the FDI move in developed countries mostly for the high-technology production. In developing countries, FDI are drawn for the labor-intensive and low technology production. Actually, in the globalized economy, this trend in FDI flows follows the international division of the labor between the developed and developing countries: those operations, which are not standardized and require highly skilled labor, are located in developed countries whereas standardized operations that can be performed by low-paid workers are located in the developing countries. This course provides opportunity to developing countries to benefit from their abundance of cheap labor and transfer the underemployed labor to manufacturing industries (Bresser Pereira, 2010, p. 46).

It is a challenge to identify and evaluate the importance of the determining factors for FDI, because it is related to the various characteristics that are specific for each country and sectors. Just to name a few: the size and potential for growth of the host country economy, natural resources, quality of workforce, trade openness, infrastructure, and proximity of the targeted markets.

Campos and Kinoshita (2003, p. 21) highlight three main factors that drive FDI in transition countries: agglomeration that comes from large market size, generous natural resources and cheap labor. In addition, countries that have good institutions, are more open to trade, and are less restrictive to FDI flows have a better chance of receiving more FDI. The sector in which the investor works is also influencing the main motives for FDI. For instance, investors that operate in natural-based industries would choose the location for their investments based on the abundance of natural resources. For those that are in the export-oriented industries, more important factor will be the availability of cheap labor. However, not only the labor cost, but also the labor quality should be one of the key factors for the potential foreign investor. The common sense is that when the workforce is more educated, it would take less time and money to educate and train local workers in using the new technology or adapt to a new management approach.

In order FDI benefits to transform into spillovers, the host country should possess certain level of absorptive capacity, to be able to assimilate and integrate FDI into the economy. Massoud (2008, p. 3) is referring to the absorptive capacity as the host country's ability to absorb FDI, and hence benefit from its potential externalities. With reference to the absorptive capability, Borensztein et al. (1998, p. 117) argue that only when there is a minimum threshold of human capital stock in the host country, FDI would be more productive in comparison to investment by a local enterprise.

How does Macedonia stand in terms of these factors, compared to the other countries in the region? Is the economic climate in the country relatively stable? Can the human capital meet the needs and requirements of the foreign investors? On the other hand, to what

degree FDI help to alleviate the high unemployment in the country? These are some of the questions addressed in this paper.

Being a transition economy, Macedonia is characterized by a lower economic growth rate, high trade deficit, and stubbornly high unemployment rate. As with the other countries of this rank, FDI are considered as one of the most important factors to accelerate the economic growth and overcome these poor economic parameters. In particular, FDI are considered as one of the key job creation resources that would mitigate the high unemployment, one of the most burning economic and social issues in the country. Still, according to the statistical data, Macedonia is persistently at the bottom of the list of countries in attracting FDI.

The purpose of this master thesis is to understand the spillover effects of FDI on the Macedonian economy, with special focus on employment. Hence, the hypothesis tested in this paper is formulated as follows:

FDI is one of the key resources to increase the employment in Macedonia.

In assessing this hypothesis, the FDI will not be considered as an aggregate category, but from the aspect of their distribution across the different economic sectors, with special focus on the mining and manufacturing industries.

The paper is organized as follows: the first part covers the theoretical background of different aspects of the FDI phenomenon; the second part's focus is on understanding the Macedonian landscape in terms of country's attractiveness for FDI and the key challenges of the Macedonian economy; the third part relates to the empirical research of the impact of FDI on employment in the country; and the fourth part covers the summary findings of the study and conclusions that can be used for enhancing the policies in terms of attracting FDI, jobs creation and employment increase, in particular.

1 THEORETICAL FRAMEWORK OF FDI

1.1 Definitions of FDI

Among the most cited definitions of FDI is the one provided by the Organization for Economic Co-operation and Development (hereinafter: OECD) (2008, p. 17): "Direct investment is a category of cross-border investment made by a resident in one economy (the *direct investor*) with the objective of establishing a lasting interest in an enterprise (the *direct investment enterprise*) that is resident in an economy other than that of the direct investor. The motivation of direct investor is a strategic long-term relationship with the direct investor investor investor of establishing a lasting influence by the direct investor investor.

in the management of the direct investment enterprise. The "lasting interest" is evidenced when the direct investor owns at least 10% of the voting power of the direct investment enterprise."

This definition is based on the concept of direct investment defined by the International Monetary Fund (hereinafter: IMF), and updated in the "Balance of payments manual, sixth edition (BMP6)" (2009, p. 100, 101): "Direct investment is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in one economy makes an investment that gives control or a significant degree of influence on the transfer in another economy... A direct investment that gives control or a significant degree of influence on the management of an enterprise that is resident in one economy makes an investment that gives control or a significant degree of influence on the management of an enterprise that is resident in another economy... A direct investor is an entity or group of related entities that is able to exercise control or a significant degree of influence by a direct investor... Control or influence may be achieved directly by owning equity that gives voting power in the enterprise, or indirectly by having voting power in another enterprise that has voting power in the enterprise. Accordingly, two ways of having control or influence or influence are identified:

(a) **Immediate direct investment** relationships arise when a direct investor directly owns equity that entitles it to **10 percent or more** of the voting power in the direct investment enterprise... (b) **Indirect direct investment** relationships arise through the ownership of voting power in one direct investment enterprise that owns voting power in another enterprise or enterprises, that is, an entity is able to exercise indirect control or influence through a chain of direct investment relationships... In addition to direct investment relationships between two enterprises that arise because one enterprise controls or influences the other, there are also direct investment relationships between two enterprises that are both under the control or influence of the same investor."

The United Nations Conference on Trade and Development (hereinafter: UNCTAD) (2012b, p. 3) almost identically defines FDI as "an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise, affiliate enterprise or foreign affiliate)."

Moosa (2002, p. 1) simplifies the FDI definition as a process in which residents of one country buys ownership of assets to control the activities of an enterprise in another country. The former country is a source country, while the latter is the host country.

The National Bank of the Republic of Macedonia (hereinafter: NBRM) (2015, p. 1) follows the definitions and manuals of IMF and OECD on FDI in compiling the statistical reports such as the International Investment Position, a statistical report on the country's international financial assets and liabilities. Accordingly, these assets and liabilities are classified as direct investments, portfolio investments, financial derivatives, employee stock options, and other investments and reserve assets.

All these definitions capture the key elements of FDI:

- The investor and the enterprise, where the investment is done, are residents of different economies;
- The investment implies a long-term relationship between the two subjects; and
- The investor has a substantial involvement and impact on the enterprise management.

A direct investor can be an individual, an enterprise, private or public, government, or governmental agency. There is also growing trend of individuals investing in so-called collective investment institutions (hereinafter: CIIs) that can act themselves as direct investor. Consequently, if both, the investment of individuals in CIIs and the investment by CIIs in other enterprise are meeting the basic criteria, then they should be considered FDI.

There is a distinction between FDI and a **portfolio foreign investment** - an investment in foreign securities. What makes FDI different from a portfolio investment is the long-term interest that the investor has in the investment enterprise, and that FDI controls one tenth or more of the capital in the investment enterprise. The possession of at least 10% of the voting power in the enterprise where the investment was done is taken as a threshold, because it is considered as minimal percentage, which allows the owner to influence the key management policies and decisions of the subject enterprise. The possibility to exercise control over an enterprise is the key characteristic of FDI that makes it different from portfolio investment. Portfolio investment could be in form of investment in stocks or bonds of foreign enterprise, however, the portfolio investor neither pursues control nor has a long-term interest in the investment enterprise. In this case, the investor is only interested in earning some profit from investing in these stocks or bonds.

Components of FDI are the initial and all subsequent investments between the investor and the enterprise, as well as reverse investments and those between fellow enterprises. This implies that for the investment to be considered as FDI, it does not necessary have to be an international capital flow and cross the borders between different economies. FDI may also occur by expanding operations of an existing foreign business within certain economy. That expansion could be financed with funds raised in that host country, through borrowing from banks, issuing stocks and bonds, or retaining profits earned by the foreign business. In addition, the multinational enterprises (hereinafter: MNEs) are not the only entities that undertake FDI. FDI can also be conveyed by, for example, a group of independent investors, which may acquire 10 percent or more of the equity of a foreign enterprise.

1.2 Multinational Enterprise

While FDI refers to the process, multinational corporations or enterprises are the business entities that convey these processes. Both FDI and MNE as phrases describe separate but related and intertwined phenomena in the area of international business; however, they should not be used as synonyms.

FDI is a financial process linked to enterprises that control business operations in at least one country, which is not their country of origin - home country. Dunning and Lundan (2008, p. 8) define MNE as "an enterprise that engages in FDI and organizes the production of goods or services in more than one country." In other words, MNE is a tangible entity that influences through its business operations both, its home country, and the other (one or more) countries, hosts of its FDI. Home country is the country where MNE usually began its operations; its top management is located; and dominant percentage of its shareholders reside. Home country as such should not be confused with the tax-haven country, where MNE could register its official place in order to reap benefits from tax-related concessions; so-called special purpose entity (hereinafter: SPE). SPEs are entities that have "few or no employees, little or no physical presence in the host economy, whose assets and liabilities represent investments in or from other countries, and whose core business consists of group financing or holding activities" (OECD, 2013, p. 18).

MNE can get a variety of forms. It can range from a small enterprise, which has a managerial influence over a business entity with few employees and modest output from another country, to huge corporations that include plants in several countries and control significant share of the markets in these countries. An MNE can be privately owned and managed; controlled either by small group of owners/investors or widely traded on stock markets. An MNE can also be publicly owned and managed by the state, a government-owned enterprise - parastatal. On the other hand, not every enterprise doing business globally is MNE. Exports or presence in another economy through salespeople or wholesale distribution center does not mean having managerial control over a subsidiary in that foreign economy. In the literature, other vastly used terms to describe this type of a business enterprise are multinational corporation – MNC or transnational corporation - TNC.

UNCTAD (2012b, p. 3) defines TNCs as "incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates." The parent enterprise is the one that has control over the assets of other entity in other country. As mentioned earlier, that

control is usually exercised through ownership of 10% or more of voting power in the other enterprise – foreign affiliate.

The foreign affiliate can have a form of a subsidiary, an associate company, or a branch. A **subsidiary** is an enterprise where the foreign investor controls more than 50% of the voting shares and has the power to influence the appointment or dismissal of the Board of Directors members or a supervisory body. The investor could exercise this control either directly or indirectly through another subsidiary. In an **associate company**, the investor (directly or through its subsidiaries) has control between 10% and 50% of the voting shares. A **branch** is an enterprise established in the host country that represents or carries out the business activities of the investor. It can take a form of a permanent office of the investor, or as a partnership or joint venture. In addition, a branch can also be considered an enterprise where the foreign investor contributes with fixed assets (equipment, land or other), but for a period longer than one year. In addition, UNCTAD considers the **structures** as a separate category. The structures can be owned by government, and also include objects, immovable equipment, and mobile equipment (gas/oil-drilling rigs, ships and aircraft) that are owned by foreign resident and operate in the country for more than one year.

MNEs do not necessarily originate from developed economies only. In the past decade, there is a growing number of MNEs from emerging and transition economies of the new European Union (hereinafter: EU) member states investing in targeted niches or in the essential segments of global value chains in selected industries. These outward FDI from the new EU member states (such as Czech Republic, Hungary, Poland and Slovenia) are concentrated mostly in the neighboring countries and other transition markets, that are not part of the EU, but becoming EU members is part of their development strategies (Dunning, Kim & Park, 2006, p. 6). This trend helped the transformation and restructuring of the new MNEs, which also positively influenced the transition process of the new EU member states. One of the identified barriers for further progress in this direction is the lack of experience and holistic knowledge about outward FDI and internationalization of the management. It requires cooperation between the home government and the private sector in reforming of the education system towards producing trained global managers (Svetličič & Jaklič, 2007, p. 199).

1.3 Forms of FDI

FDI can be classified according to various criteria. One of these criteria is the motivation, the business objectives of MNE for involving into FDI. The corporate executives will decide to go with the FDI once they come to a conclusion that the future financial results will outweigh the costs of entering into FDI action. However, it will depend on the nature

of the MNE and its objectives how this goal is reached. Accordingly, Cohen (2007, p. 66) distinguishes four sub-categories of FDI:

- **Resource-Seeking FDI** one of the earliest forms of FDI, which was predominant form of FDI until after World War II. This form of FDI is undertaken by enterprises that are working in the extracting industry (minerals, metals) and tropical commodities (tropical fruits and rubber). Geology and climate were and still are the key determinants for this type of FDI where these minerals and metals are located, and where the climate is the most convenient for growing tropical products. Additional determinants are the transportation infrastructure and accessibility of raw materials, as well as the good governance, rule of law and government tax policies.
- Market-Seeking FDI a typical follow-up to the initial marketing strategy based on exports. The investing enterprise decides to set up an operation in a foreign country in order to be closer to the existing and potential customers; to better position itself on the foreign market against the local competitors or subsidiaries of other MNEs; in response to stricter import barriers or expected unfavorable exchange rate fluctuations of the home country's currency. Another important motive for this type of FDI might be the reduction of time and cost in transportation, especially important factor when dealing with bulky and heavy products. Furthermore, physical presence on the foreign market improves the MNE's ability to be responsive to, and in anticipating of, the changes of local customers' tastes and preferences. It also improves MNEs image as contributor to the economic growth and job creation in the host country. Market-seeking FDI is initially drawn to large, lucrative, and growing markets that provide both, customers and skilled labor.
- Efficiency-Seeking FDI the goal of this type of FDI is to reduce the production costs, by investing in economies characterized by cheap labor, and in those that enable achieving economy of scale. Low-paid workers are usually low-skilled workers as well. Nevertheless, if these workers have work ethic, they can be proved as cost-effective in operations that are low-tech and labor-intensive, but also in operations that are characterized with standardized and mature technology. In order to remain or become more competitive, especially in industries that are capital-intensive and with high initial development and production costs, the MNEs are forced to seek for investing in countries that provide better economies of scale. This type of FDI can negatively affect the employment in home countries. Labor unions in these countries are arguing that in order to reduce production costs, MNEs are closing their operations in the home country and are moving to less-developed countries, where the labor is cheaper. On the other side, efficiency-seeking FDI could positively affect the economic growth of the host country. It could have a positive effect by reducing the unemployment, although it would not necessarily increase the labor skills or the salaries. Most of the efficiency-

seeking FDI operations are export-oriented, thus increasing the host country income from the foreign exchange. In addition, local enterprises could benefit from their adaptation and imitation of the FDI operations.

• Strategic Asset-Seeking FDI – the motive for such FDI is to strengthen MNE's competitive position through acquiring strategic assets in a foreign enterprise. That maneuver may help MNE to broaden its assortment and technologically improve its products, as well as to weaken competitors' position by preventing them to acquire these assets. The ultimate beneficiaries of this type of FDI would be the MNE's shareholders. This form of FDI is common in the developed countries.

From the aspect of the role that FDI plays in the MNE's global production strategy to gain competitive advantage, there is a distinction between horizontal and vertical FDI.

With the **horizontal FDI**, the MNE replicates its production activities in other countries in order to access their markets. This form of FDI is most common in the manufacturing sector, where a portion of the domestic production is transferred abroad in order to strengthen the competitive position of the MNE. This transfer would initially trigger a decline in the exports of those products from the home country, however, that might be compensated by export increase in other products. The foreign operations might initiate increased export of certain product components, equipment and spare parts that are required for their production processes, as well as export of complementary product models that are produced only in the home country. Similarly, a portion of jobs in the home country would be initially eliminated; however, the redundant workforce could be employed in the other production operations of the MNE in the home country or find jobs in other enterprises.

In case of **vertical FDI**, MNE fragmentizes the production process in several countries, in order to reap the benefits of their individual comparative advantages in particular production stages and thus minimize the production costs. Various parts of the final product are manufactured in two or more countries. One of the typical cases of vertical FDI is outsourcing of the production stages that are labor intensive, low-tech and easily routinized (including more sophisticated ones in services recently) to countries characterized with relatively cheap labor, which are typically developing countries, while operations that are capital-intensive and require high skills are mostly located in the developed countries. The geographic specialization of different production stages fosters the growth of intra-corporate trade, since the intermediate goods are exported from host country for final product assembling (**forward vertical FDI**). Many host countries in order to attract FDI are opening export-processing zones (hereinafter: EPZs), where MNEs are opening subsidiaries to produce certain intermediate products that will be exported to

another country, where the final assembly takes place. These EPZs usually have special judicial treatment; they are usually exempt from most of the regulations, import tariffs and certain corporate taxes.

There's another category of FDI – **conglomerate FDI**, that refers to cross-border mergers and acquisitions (hereinafter: M&As) between two enterprises from different countries that are neither in the same industry (as horizontal FDI) nor are they related through a vertical supply-chain (as vertical FDI). For example, an MNE could engage in a cross-border acquisition in order to make a profit from an undervalued stock market in another country.

Another basis for classifying FDI is the method how a foreign operation (subsidiary or affiliate) was established. Most of FDI happened either as greenfield investments or as M&As.

A greenfield investment occurs when the investor builds the foreign business from scratch as a wholly owned company or a joint venture. It is an investment in new production, distribution or other capacities in the host country. Host countries look favorably to these investments, since they are generating new jobs and increasing the value-added production. On the other side, these investments can negatively affect the local industry, causing a crowding-out effect. The MNEs are able to produce cheaper products, because usually they have more advanced technologies and processes. In addition, the profits earned from these investments, if not re-invested, are transferred to the MNE's home country.

Merger involves consolidation of two enterprises into one new entity. In order to be considered as a type of FDI, those two enterprises should be headquartered in two different countries. When the investor makes a procurement of voting stock in already existing foreign enterprise, that takeover is considered as an **acquisition**. The foreign investor acquires the company, takes the control over the acquired enterprise from the local owner, and in most of the cases, completely reorganizes the business processes, both in infrastructure and management. The acquired enterprise becomes an affiliate of the MNE.

M&As are considered as less costly and risky, mainly because, if the acquired company is a loss-maker, characterized with poor management and financial losses, it would be bought at a lower market price, and the investor can access the market quicker than when establishing a brand new operation. For the host country, these investments are less favorable than the greenfield ones, at least in the first instance. The basic logic for that position is that M&As are essentially a transfer of the ownership, which may result with drastic re-structuring of the operation, the new owner would initially focus on cutting costs in the makeover stage that would end up with significant lay-offs or termination of some less-profitable activities. In later stages, when the management is improved and the production processes are more efficient, the new owner might expand the business in the acquired foreign enterprise. At the moment of the merger or acquisition, these actions do not increase the productive capacities of the host country. In that line, Cohen (2007, p. 73) indicates that "incrementalism" is the key difference between greenfield investments and the M&A, because, while the greenfield investment creates an increment economic activity, M&A only changes the ownership of the activity. M&As are becoming even more sensitive issue when they are executed in such area as the media sector, because they might be perceived as a potential threat to the national identity or culture. If there is time and investors possess all the necessary knowledge, FDI can take the form of greenfield investor needs some additional local partner knowledge, then acquisition is better option.

Foreign subsidiary could be established through **privatization** as well. The seller in this case is the government of the host country. Privatization process was especially intrinsic in the transition process from planned to market-based economy of the countries from the former Eastern bloc, including former Yugoslav republics. Once privatized, these enterprises could change ownership between private entities (unless they become renationalized), in which case that transfer falls in M&A category.

Beside starting a brand new business or invest in the already existing operation, either through an acquisition or a merger, the foreign investor can also invest in a **joint venture**, which is practically a partnership between a foreign enterprise with domestic enterprise or a government institution. Basically, it is a new entity, where one side usually provides technical expertise and financing capabilities, and the other side provides expertise in local laws, regulations, or bureaucracy. Both sides have control over the operation and share the revenues, as well as the expenses and assets. Another form of partnership is the **strategic alliance**. What makes it different from the joint venture is that, unlike creation of a new entity, strategic alliance represents collaboration between two enterprises from different countries that remain legally separate entities.

From the aspect of the methods of financing, MNE could finance FDI in several ways. One method is **transfer of hard currency** from the home country to the host country. This inflow of hard currency has a positive impact on the host country's balance of payment and economic development, because it provides additional resources to finance the trade deficits and to pay for importing goods and services that would be used to stimulate the economic growth and increase living standard. Alternatively, MNE could finance its FDI by taking **loans from the banks or issuing bonds on the capital markets of the host country**. The downside of this method of financing FDI is that the host country is missing the opportunity to earn through the exchange rate when changing the MNE's hard currency into the local one. In addition, lending to the foreign investors can result with crowding-out effect, since it reduces the availability of funds for lending to the domestic enterprises.

The World Trade Organization (hereinafter: WTO) (1996) makes a distinction among three forms of FDI:

- Equity capital the MNE investment in the shares of a foreign enterprise, and it includes the previously explained greenfield investments and M&As;
- **Reinvested earnings** portion of the earned profits returned in the foreign enterprise instead of dispersed as dividends or transferred to the MNE; and
- Other capital mutual borrowing and lending of funds between the MNE and the foreign enterprise-affiliate.

From the host country perspective, there are import-substituting FDI, export-increasing FDI and government-initiated FDI (Moosa, 2002, p. 5).

Import-substituting FDI is motivated with reducing the import of goods by their production in the host country.

Export-increasing FDI is triggered when the investor is looking for new sources of raw materials or intermediate goods. In such cases, that investment would result in export increase of these raw materials and intermediate goods for the host country, when they are exported to the country of the investor or to another country, where the investor's subsidy is located.

Government-initiated FDI occurs when the host country government offers incentives to stimulate foreign investments in order to achieve certain objectives of its economic policy.

FDI can also be classified as inward and outward. When one country invests in another country, that is an **inward FDI for the recipient country, and** an **outward FDI for the investing country**.

1.4 FDI Theories

The important role that FDI play in the economic growth of a given economy motivated the interest in trying to understand what drives FDI to take place in certain environment. As a result, various FDI theories were developed. These theories intent to provide certain clarification on what drives MNEs to undertake FDI; why they choose certain country vs. other country to invest in; why certain countries are more successful in attracting FDI than others. Regardless of various FDI theories, what makes the core interest of each investor remains to be the profitability (or the perceived one) of each one of these investment projects. Some of the most referenced theories are elaborated in the following selection.

1.4.1 The differential rates of return hypothesis

This is one of the earliest hypotheses, according to which the capital tends to flow from countries with low rates of return to countries with higher rates of return. This process ultimately results with the equality of *ex ante* real rates of return. The investment decision depends on the rate of return only. The hypothesis is based on risk neutrality, implying that, for the investor, the direct investment in any country is a perfect substitute to the direct investment in any other country, i.e. domestic and foreign direct investments are perfect substitutes.

One of the deficiencies of this hypothesis is that it implies only one direction of capital flows – from countries with low rate of return to countries with high rate of return. It completely neglects the fact that countries do have FDI inflows and outflows simultaneously. In addition, the profit may not always be a reason for FDI. For instance, companies may invest abroad in order to maximize their sales revenues with market penetration. Alternatively, they might invest in other country in order to bypass the trade barriers. Furthermore, FDI decision usually does not depend on return only, without taking into consideration the risk as well.

1.4.2 The portfolio diversification hypothesis

The origin of this hypothesis can be tracked back to the theory of portfolio selection of Tobin (1958) and Markowitz (1959) (in Moosa, 2002, p. 26). According to this hypothesis, the decision to invest in certain project versus the others is determined by not only the expected rate of return, but the risk as well. The capital flow is restrained by the intention to reduce the risk, and that can be achieved by diversification, which is an underlying assumption for the portfolio investment, too.

The diversification hypothesis overcomes the deficiency of the differential rates of return hypothesis, by considering risk, as one of the key elements when decision about FDI is brought. It also explains the simultaneous FDI inflows and outflows in the countries. However, this hypothesis does not provide explanation why the MNEs are the greatest FDI investors, and why they prefer FDI to portfolio investment. One of the explanations for this might be the financial markets' imperfections, which are typical for the developing countries, and they discourage portfolio investment over FDI.

1.4.3 The market size hypothesis

The market size hypothesis postulates that the volume of FDI in a host country is related to its market size. The bigger the market size, measured by the country's Gross Domestic Product (hereinafter: GDP) or the sales of the MNE in that country, the more attractive country to invest in. When the market of the host country grows to the level that provides the economies of scale, that country becomes more attractive for FDI inflow. Several studies on the market size as a determinant for FDI inflows find a positive correlation between the volume of these parameters and the FDI.

1.4.4 The industrial organization hypothesis

This hypothesis was developed by Hymer in his PHD thesis (1960), published only in 1976. It stipulates that a firm, which is opening a subsidiary in another country, is facing several disadvantages when competing with local firms. These disadvantages come from different language, culture, mentality, customs, legal system, and other. Therefore, in order to be competitive on that market, the firm-investor in that country has to possess some advantages over the local firms. In most cases, these advantages stem from the firm's intangible assets, such as its brand, patented technology, superior managerial and organizational skills.

According to Lall and Streeten (1977) (in Moosa, 2002, p. 30), these intangible assets cannot be sold to other firms, simply because they are intrinsic, deep-rooted in the organization, or they are difficult to define, value, and transfer. These firm-specific advantages explain why that firm is competitive on a foreign market. However, this approach fails to explain why that firm is not using its competitive advantages to produce in the home country and then export abroad, instead of pursuing FDI. Some of the reasons for that would be lower production costs in other countries due to the cheaper production inputs (raw materials or labor). Furthermore, this hypothesis fails to explain why firms decide to invest in one country instead of another country. This question is addressed in the location hypothesis.

1.4.5 The location hypothesis

The main postulate of this hypothesis is that FDI happens due to the international immobility of some production inputs, like natural resources or labor. For example, the wages in the home and host countries – the difference in their levels can be an important determinant of FDI. In general, countries with cheap labor attract investments in labor-intensive production from the countries where the labor is more expensive. On the other hand, high wages can be an indicator of high quality of labor. Consequently, in the sectors where the quality of labor matters, e.g. financial sector or research and development (hereinafter: R&D), the investment is less likely to be relocated to a country with lower wages in these sectors. Furthermore, the higher labor productivity may outweigh the lower labor cost when considering the investment location. This may be one of the reasons why the most developed countries, which are characterized with high wages among other factors, are still the most attractive FDI markets.

There is another phenomenon related to the wage rate in the host country: the rise in the wages results in change of the relative prices of the production inputs, which, consequently, leads to shifting towards more capital-intensive processes, and hence to more FDI. The low wages are not the only location advantage that affects the location of FDI. Other factors of production can also be relatively cheaper in other countries than in the home country, like power or natural resources, which could affect the decision about the FDI location.

1.4.6 The internalization hypothesis

Some consider this hypothesis as a general theory for FDI, and the other theories are just its subsets. In a nutshell, this theory explains that FDI is a result of the firm's efforts to replace market transactions with internal ones. According to Buckley and Casson (1976) (in Moosa, 2002, p. 32), firms have incentives to bypass the imperfect markets of intermediate products, by creating internal markets. The internalization of the markets across the national boundaries in order to avoid or minimize transaction costs leads to FDI. This process will continue until the marginal benefits equal marginal costs.

The internalization hypothesis provides an explanation why companies prefer FDI to export and import from other countries and why they avoid licensing. In order to avoid the transaction costs related to the purchases and sales on the market, and to save on significant time lags, these companies are oriented towards replacing the market functions with internal processes. Hence, the goal of the internalization process is to eliminate these uncertainties.

1.4.7 The eclectic theory

Dunning (2008, p. 95) developed this theory by integrating three other hypotheses: the industrial organization hypothesis, the internalization hypothesis and the location hypothesis. This theory tries to provide answers to the following questions:

- When there is a demand for a certain commodity in a particular country, why this demand is not met by a local firm that produces that commodity, or by a foreign firm that exports that commodity from another country?
- If a firm intents to expand the scale of its operations, why does it not choose another approaches, like producing the commodity in its home country and then exporting it to foreign markets, expanding its operations in a new line of business in the home country, making portfolio investment abroad, or giving license for its technology to a foreign firm to do the production?

A simple answer to these questions is that FDI is more profitable than all these other ways of expansion.

This theory lays out the famous OLI paradigm or framework, which refers to the three conditions or advantages that must be met for a firm to engage in FDI:

- The firm must possess some intangible assets that give comparable advantage over other firms (ownership over specific technology, monopolistic position, access to cheap finance or raw materials) ownership advantage.
- It must be more profitable for the firm to locate its production abroad, and it is cheaper to produce in the foreign country than domestically (due to cheap labor or raw materials); otherwise, it would be better to export than invest abroad location advantage.
- Using these comparable advantages by running the operations within the firm should be more beneficial than exporting, franchising, or leasing them to other firms internalization advantage.

1.4.8 The product life cycle hypothesis

According to this hypothesis, firms decide to undertake FDI at a certain stage in the life cycle of their products, which initially were their innovations. Vernon (1966, p. 191), who developed this hypothesis, identified three stages:

- The initial production stage. At this stage, the production takes place at home, to be close to the customers, and to have a close coordination between the production and the R&D units. During this initial stage of the product life cycle, the demand comes from domestic customers, the firm can charge high price, due to the price inelasticity driven by the demand of the new product. During this stage, the innovating firm undertakes improvements of the product in response to the feedback from the customers.
- In the second stage, the product is exported in developed countries where the demand for this product emerges. As the demand grows and the competition arises, in order to meet the local demand, the firm turns to FDI in these countries. The home country is still net exporter and the foreign countries are net importers of the product.
- In the third stage, the product is no longer a novelty but a standardized product, the price competition from other producers urges the firm to look for cost advantages by investing in developing countries. The home country is net importer, while foreign countries net exporters of the product.

When the product reaches the stage of maturity and standardization, the cost of production becomes increasingly important, and in order to keep the competitive advantage against the domestic and foreign competitors, the firm engages in FDI.

When this theory was developed in 1960s, the United States of America (hereinafter: USA) was the leading country in R&D and innovation. However, now the new products are innovated in other developed countries besides USA. Hence, the production units are located in more than one country, and FDI cannot be explained by the simplified product life cycle hypothesis. In order to address this shortcoming, the hypothesis was expanded to take into account other factors' costs besides the labor cost, and it was made more general in order to become applicable to FDI in all developed countries.

1.4.9 The oligopolistic reactions hypothesis

This hypothesis, developed by Knickerbocker (1973) (in Head, Mayer & Ries, 2002, p. 1), explains follow-the-leader behavior of the enterprises in the foreign markets. In an oligopolistic environment, the competitors cannot ignore the actions of the others. When one firm establishes a production facility in another country, the competitors perceive that as a threat of the status quo and they feel forced to counteract. In order to counter any competitive advantage that the first firm might achieve by the FDI, the oligopolistic firms undertake their own FDI, so that maintains the competitive equilibrium.

1.4.10 The internal financing hypothesis

According to the internal financing hypothesis, the firm initially invests a relatively modest amount of its resources for the direct investment, while the reinvested profit generated from that investment in the foreign country is financing the subsequent growth. In other words, the investor is using the profit earned by the subsidiary to expand the FDI in the country where that subsidiary works. The hypothesis indicates that there is a positive correlation between the internal cash flow and the investment disbursements, which is reasonable given that the internal financing is cheaper than external financing. One of the explanations for that is the existence of the informational imperfections on the capital markets.

This hypothesis explains the FDI in the developing countries from two aspects: (1) the movement of funds in these countries is restricted; and (2) the financial markets are rudimental and inefficient.

Another explanation of why MNE prefers internal financing is that, in most home counties, the MNE is tax-liable for repatriated earnings, so MNE prefers to reinvest those earnings back in the subsidiary to the greatest possible extent. Hence, we can make a distinction between mature and immature foreign operations or subsidiaries. The immature subsidiaries are making fewer remittances and they are more financially dependent from the MNE.

1.4.11 The currency areas hypothesis and the effect of the exchange rate

The focus of this hypothesis, developed by Aliber (1970) (in Dunning & Lundan, 2008, p. 90), is the relationship between the currency value and the FDI flows. The countries that have strong currencies are more home countries – sources of FDI (FDI outflows), while the countries that have weaker currencies are more host countries – recipients of FDI (FDI inflows). The exchange rates play an important role for the FDI. When the domestic currency is appreciated against the other currencies, the domestic goods will become less competitive and MNEs will face difficulties to export. If the appreciation of the domestic currency continues, MNEs might determine that it would be more beneficial to move abroad, which consequently would lead to increase of FDI. The hypothesis fails to explain the cross-investment between currency areas, the investment between countries that are in the same currency area, or the FDI concentration in selected industries.

1.5 FDI Effects on the Host Country Economy

The effects of the FDI can be different for the country of origin of the investment – home country, and the recipient country – host country. These effects can be both positive and negative, as costs and benefits from the FDI. In principle, both countries before entering into the investment must believe that the expected benefits will outweigh the costs from that undertaking. However, that belief might not always materialize.

The effects of the FDI could be grouped in three categories:

- Economic effects (consequences on the output, market structure, the balance of payment);
- Political effects (related to the national sovereignty the influence that big MNEs can have on host country government); and
- Social effects (cultural effects on customs and tastes of the local population, the creation of foreign elite in the recipient country).

The focus of most of the analyses of FDI effects is on the economic impact that FDI have on the host country. The expectations of these impacts on host country economy are very high. FDI are being looked as the main way of rescuing from the poverty. However, various analyses show that the effects of the FDI are not always beneficial to the host country economy. In some cases, they can be detrimental. Whatever the effects, one should keep in mind that MNEs are making investments to maximize their profit, not because of charity.

The economic effects are viewed from the aspect of provision of capital, the output and growth, the balance of payment, the trade flows, productivity, technology, training, inter-

industry linkages, market structure, environment, and the employment and salaries - the key area of research in this paper.

1.5.1 Provision of capital

MNEs' entrance in certain economy can encourage other MNEs to follow. FDI can also be followed by official development assistance from the home country (in case of developing countries), and it can activate the domestic saving by offering attractive opportunities for investment. With the support in overcoming the foreign exchange gap, FDI also can have a positive effect on the host country's balance of payment. Lall and Streeten (1977) (in Moosa, 2002, p. 72) on the other hand are arguing that the FDI are not cheap source of capital. The capital provided by the MNE may not necessarily be large, especially if MNEs can borrow from the host country to undertake the FDI. Their capital contribution can take shape in machinery or knowledge and goodwill, in which cases the capital is small in volume and expensive indeed.

1.5.2 Impact on the output and growth

FDI have an effect on the host country's output and its economic growth; with capital stock increase as result of it, or efficient exploitation of the existing resources in the cases of takeover. Many theories of economic development highlight several factors for economic growth: capital accumulation, technological progress, population growth, or discovery of natural resources. However, of all these factors, the capital accumulation comes up as the leading force of the economic growth. Hence, FDI, with its contribution to the capital accumulation, should be influencing the economic development.

In addition, the level of adoption and implementation of the latest technologies that are in use in the developed countries, also affect the economic growth rate of the developing countries. Borensztein et al. (1998, p. 123) provide empirical evidence on the effects of FDI on the economic growth of the host country, based on the rate of technological progress as a main determinant in their model of endogenous growth. While MNEs are capable of bringing advanced technology, the impact on the host country growth depends also on its absorptive capacity, determined by the level of development of its human capital.

1.5.3 Effect on the balance of payment

The FDI effect on the balance of payment is different for the source and the host country. While the source country experiences a sudden deficit when FDI takes place, the host country has a small, yet continuous, deficit due to the profit repatriation from a profitable FDI. The FDI effects on the balance of payment can be direct and indirect.

The direct effect is a result of the investment flows, both inflows and outflows. The inflows take form as exports, equity capital inflows, loans from abroad without capital and repatriated loans. The outflows refer to the value of the imported capital goods, the value of the imported raw materials and intermediate goods, after-tax royalties and technical fees that are paid abroad, and net after-tax profits and interest ensuing abroad. The direct effect fails to explain what would have happened if the FDI did not materialize, and what the FDI effect on the balance of payment is through domestic sales and local resources, which in essence, is an indirect effect.

1.5.4 Effect on trade flows

The key issue is whether FDI and trade complements or substitutes each other. There are instances when FDI complements trade. Through FDI, companies can develop bigger distribution base, and in that manner to increase the sales of its product on the foreign market in comparison to the sales volume via exports only. In addition, the production process in foreign country would need intermediate products from the home country, which means increase exports. And *vice versa*: the cheaper products produced in a foreign subsidiary would be more affordable in the home country and in that way the FDI would lead to increased imports in the home country. When we look at the FDI and trade as two alternative modes of entry in the foreign market, then we can consider them as substitutes.

In general, whether FDI and trade are complementary or substitutes to each other depends on whether the FDI is horizontal or vertical. In case of **horizontal FDI**, firms are opening new facilities in foreign markets to produce the same goods as in home country (Markusen, 1984, p. 184). Consequently, the export of these goods from the home country will decline to these foreign markets, in which case FDI is substitute to the trade. In case of **vertical FDI**, firms are distributing different production stages of their goods in different countries, in order to benefit from lower prices of production factors in these countries (Helpman, 1984, p. 460). The production stages that are more labor-intensive would be located in countries characterized by lower wages. In such cases, there is increased import of intermediate products in the host country that has cheaper labor, and the export of finalized goods from the host country, where the subsidiary is located, will be increased. Therefore, FDI and trade complement each other.

1.5.5 Effect on productivity

The FDI will positively affect the increase in productivity and decline of a unit price when FDI promotes exports and when subsidiary produces goods that are distributed in the larger foreign markets. These positive effects will occur also when the business environment and policy would enable production facilities established in these countries to achieve bigger economies of scale. Conversely, when FDI substitutes the import and when the market size

is too small to achieve economies of scale, the FDI might not significantly affect the productivity increase. However, the productivity might not always be the most important factor for FDI. There is empirical evidence that the unit costs in a facility that is smaller than the optimal size are not much higher than the ones in a facility that can achieve the most efficient scale of production. In addition, even when FDI is undertaken to substitute import, any range of export is enlarging the market size, and consequently leads to utilization of the more capital-intensive technology.

1.5.6 Technology effect

FDI is considered as one of the main channels to transfer the technology in the developing countries. It is one of the most important aspects of FDI, because the technology is considered as one of the key resources of the economic growth, increased accumulation of capital, and greater trade intensity. Consequently, what matters to the developing countries is how the technology would be transferred into their economy, how the country can absorb the transferred technology, and what impacts it would have on its economy in general.

However, the technology transfer can also have adverse effects on the host country economy. It could negatively affect the employment, by making the workforce with certain skills redundant and imposing its' retraining. The developing countries, being in dire need of more advanced technology for their growth, have little information about the technology – subject of negotiations and the price of the transfer. That gives MNEs an opportunity to ask for high royalties, and to demand very high licensing restrictions. The benefits from technology transfer are not automatic, and many economic and technological factors have an impact on the effects.

1.5.7 Training effect

Although the training of local workforce usually is considered as sunk cost for the foreign investors, it might be essential for the successful outcome of the investment. It is normal for the foreign investor to bring expatriate personnel at the beginning of the new operations in another country. However, it is also to their benefit to limit their number and to use more local people sooner rather than later. This approach is influenced by the higher costs related to the remuneration of the expats compared to the wages of the local personnel. In addition, the host country government can also make pressure to hire more of the local workforce.

1.5.8 Effect on the inter-industry linkages

FDI can provide opportunities to the local firms for supplying the subsidiaries with locally produced materials and intermediate products. These linkages between the foreign subsidiaries and local firms, where the latter act as suppliers to the former, are called **backward linkages**. They would positively influence the employment and income generation in the local firms. When local firms are collaborating with the foreign subsidiaries in the distribution chains of their outputs, these linkages are called **forward linkages**. However, these opportunities for establishing backward linkages may be hindered by the import of the materials and intermediate products from the parent companies or other subsidiaries. In addition to these preferred supply chains, the backward linkages might be less appealing because of the lower quality of locally produced products as well. Furthermore, most MNEs are already vertically integrated and engaged in intersubsidiary transactions. In order to minimize the risk, the subsidiary could take over the local supplier.

1.5.9 Effect on the market structure

The presence of FDI can increase or decrease competition in the host country in several ways. Foreign subsidiaries, backed by their strong parent companies, can compete with the local oligopolistic companies on the local market. If the local competitors are small domestic firms, foreign subsidiaries could very easily dominate the local markets and thus prevent development of local indigenous firms and managers who could become strong enough to compete with bigger companies on the market. In such case, the entrance of FDI will have a negative effect on the local market, and the monopolistic and oligopolistic tendencies might increase.

1.5.10 Effect on the environment

It is not that rare for developing countries, in their efforts to attract as much FDI as possible, to impose less rigorous requirements for protective measures against environment pollution, and even not to insist on abiding to the already existing domestic environmental standards. On the other side, MNEs are using their financial, negotiating, even political superiority, to neglect the detrimental repercussions of their operations on the environment in these countries. With reference to the FDI effects on the environment, Mabey and McNally (1999, p. 7) highlight in their study the need not only for basic, but for increased business responsibility for the operations abroad. In addition, the international economic agreements must be in compliance with the multilateral and national environmental regulations, while the sustainable investment flows should be supported by new international regulation.

1.5.11 Effect on the employment and salaries

This aspect of FDI effects is the key area of the research in this paper. The effect that FDI has on employment can be analyzed from the aspect of the home and the host country.

From the aspect of the home country, there are concerns about the impact that FDI can have on the domestic employment and the level of salaries. These concerns are related to the process of "siphoning out" of the jobs from the industrialized economies to emerging ones (Baldwin, 1995, p. 6). With the relocation of their operations to other countries, MNEs are moving jobs from the countries with higher salaries to countries with lower salaries (Hunya & Geishecker, 2005, p. 12). The process of "taking over" jobs by developing and emerging economies relates to their growing competitive advantages in the production of low-skill labor-intensive products. Their competitiveness stems from the lower salaries of workers that are with high school or lower levels of education compared to the workers at the same level of education in the developed countries. Therefore, the workers of this category in developed countries are losing their jobs to their peers in the developing countries.

Labor unions in particular argue that foreign investment leads to a decline in production at home and subsequently exports. As a consequence, jobs are cut in home operations and they are transferred to locations with lower production costs. On the other hand, the MNEs are counter-arguing that, they have to invest in cheaper production operations abroad; otherwise, they will end up being less competitive compared with the foreign producers on the global market, which will make the cutting jobs at home inevitable. On the contrary, by transferring the lower-skilled and labor-intensive jobs to their foreign operations, they are able to keep jobs at home in high-skill and knowledge-based activities. In addition, domestic operations will continue supplying their foreign operations with capital and intermediate products. Furthermore, if the countries have higher rates of productivity, then this productivity may compensate for the higher salaries and as a result, it may not be necessary to relocate operations. This was the potential risk that arose when the new members joined the EU in 2005. On the contrary, the relocation of employment happens more between the parent enterprises and their affiliates, located in the older EU member states where the salaries are high, than between MNEs and their affiliates in the new EU member states where salaries are lower (Konings, 2004, p. 106).

Hence, the effect of FDI on employment in the home country should be analyzed from two aspects:

- The extent to which FDI substitutes for investment at home; and
- The extent to which FDI contributes to the increase of export of capital and intermediate goods to the host country.

In a nutshell, there are opposing positions with reference to the effect of FDI on the employment in the source country. Some think that the outward FDI practically closes the jobs at home, because the export to foreign markets is substituted by opening production facilities in those markets. The supporters of outward FDI think to the contrary; these outward FDI stimulate employment at home, because the firms at home export more if they have more foreign subsidiaries. However, if the operations at home are more technologically advanced and capital intensive (instead of labor intensive), it is highly unlikely that they would foster increased employment.

From the aspect of host developing countries, the issues about FDI effects on employment are slightly different in comparison.

FDI can have the following effects on the employment in the host country:

- It can directly increase the employment by opening new facilities or indirectly through stimulating employment in the distribution;
- It can keep the employment in the troubling firms at the same level, by their acquisition and restructuring; or
- It can reduce the employment by closing the facilities or divesting.

One of the reasons why developing countries are trying to attract FDI in their economies is creating new jobs that would alleviate the burden of high unemployment. However, whether all the jobs created by FDI are good ones is another question. Some of them indeed contribute to reduce the poverty and, more importantly, they transfer the knowledge (Javorcik, 2013, p. 4). Therefore, developing countries should strive in attracting FDI that would create such good jobs.

At the macro level, good jobs are considered those jobs that have the potential to contribute to a country's productivity growth.

Indeed, foreign affiliates are more productive than local enterprises. That can be explained with, what Dunning and Narula (1996, p. 1) are calling "ownership specific advantages". Namely, in order to overcome the handicap of being less familiar with the local consumer's preferences and the regulative framework, foreign affiliates have to bring better technologies, management approaches, and knowledge that would make them more productive and competitive against the local enterprises.

Another explanation for the higher productivity by the foreign affiliates is the better organizational and management process that reduces the percentage of faulty products, and cut on waste and unnecessary expenditures. Furthermore, the investment in training of the local workforce and the merit-based remuneration also contribute to better productivity.

What effect FDI will have on the employment in the host country also depends on whether it is in form of greenfield or M&A. The greenfield FDI creates new jobs with opening of the new facilities in the host country. The FDI through M&A mainly transforms the targeted enterprise, in which process of improving of its productivity, it may end up with cutting the identified redundant jobs (Hunya & Geishecker, 2005, p. 4). Hence, it is quite understandable why every country, especially developing ones, would rather prefer greenfield versus M&A type of investments from the aspect of jobs creation (Vintila & Popescu, n.d., p. 85).

However, even in case of the greenfield FDI, the situation is not black or white. If that operation is targeting the host country's market, it would eventually reduce the market portion of the domestic competitors, which might result in cutting jobs; while, on the other hand, if its entrance on the local market impacts the rise in competition and efficiency, it might create new jobs, too (Lall, 2002, p. 8). If the greenfield investment is mainly focused on exports, it would increase employment. At the macro level, if the economy is characterized with close to a full employment, the greenfield investment would take over labor from other enterprises by offering better salaries, which would increase salary levels for certain skills on the labor market. When the economy is characterized by high unemployment, it is not quite a clear cut whether greenfield investment should be favored over M&As. The high unemployment may be caused by non-flexible labor market, skills mismatch between demand and supply, or weak competitiveness and inappropriate policy framework (Lall, 2002, p. 9).

The additional indirect FDI effects on employment can be manifested through: (1) the cut of jobs in the domestic enterprises, due to the replacement of the former links with them with the traditional suppliers of the new owners, (2) the cut of jobs in the domestic enterprises caused by the establishing of subsidiaries that are more competitive due to their support by their founders - the foreign enterprises that are bigger and technologically advanced, but also (3) the creation of new jobs caused by establishing links with the local suppliers, have they proved to be more competitive (Hunya & Geishecker, 2005, p. 7).

At the micro, worker's level, good job is the job that is better paid or has potential to provide higher salaries. Many studies support the fact that foreign affiliates, in general, provides better salaries in comparison to the domestic enterprises, and this fact is valid for both developed and developing countries. These are only few of the possible reasons:

- Prevention of labor mobility to the local competitors, which would benefit from the knowledge spillover in that case;
- To stimulate not only higher productivity, but also better efficiency and effectiveness of the better-paid local workforce;

- The local workforce might absorb new knowledge with its engagement by the foreign employers and thus upgrade the local human capital and increase the productivity of the local workforce; or
- The foreign employers might offer better salaries in order to attract local workforce that is already skilled and the best available on the local labor market.

The Macedonian businessmen had already complained that, if the foreign investors are getting subsidies by the state for opening new jobs, they should employ unskilled workers registered at the Agency for Employment, instead of taking over already employed, skilled and trained workers from local enterprises, which further deteriorates any competitive advantage that the local companies might have against the foreign investors (Zdravkovska, 2015b, p. 17). The impact of FDI on employment in Macedonia is analyzed more in depth in the following chapters of this paper.

In summary, FDI can have positive effect on employment in the host country under certain conditions. Even if the impact of FDI on the total employment is marginal, they may influence the structure of employment through the demand for skilled labor, technicians, or experts (OECD, 2007, p. 68). However, it can also have a negative effect, not only on the employment, but also on the industrial interactions in the host country. Hence, OECD provides guidance for MNEs on how they should deal with this issue. In essence, MNEs should respect the employees' rights defended by the trade unions as their representatives. They should act against child labor. They should not practice any forms of discrimination against their employees and should foster negotiating collective agreements (OECD, 2011, p. 35).

1.6 FDI Policies

Over the past decades, two general approaches could be differentiated with reference to the policies of developing countries to harness FDI for their development.

The first approach is more liberal for the MNEs, allowing them to establish subsidiaries in a host country for production based on duty-free inputs that would be exported to the foreign markets. The main concern of the policymakers in the host country about this approach is that such investment would have minimal or none usage of local inputs, and very little or none backward linkages with the domestic partners. For the host country, the benefits of such FDI would be limited to employment of the workforce at low cost/wage, and some small foreign exchange surplus that would result from the difference between the value of the imported components and of the exported products. This approach can be recognized in the development strategies of Singapore, Hong Kong, and Malaysia with its special zones.

The other approach is characterized with certain conditions for the foreign investors, by imposing cooperation with local partners and some thresholds of using domestic contents in their operations (so called local content requirements). The expectations from this approach is that these requirements will result with establishing backward linkages with the local partners, technology transfer to these companies, and will consequently help developing the local industry sector in the host country. This approach is aligned with the countries from Africa, Middle East, Latin America, and some parts of Asia.

The latter approach proved to be more damaging for the local economy. Moran (2006, p. 22) argues that when the investors are required to use local partners, they are usually transferring older technology and management practices in order to prevent leakages of their most advanced technologies and other competitive assets to their potential competitors. They are also opening plants not big enough to capture the economies of scale, which leads to inefficient operations and expensive commodities. The condition to procure certain amount of production inputs from the local economy additionally increases the cost of operation. All these result with producing high-cost and non-competitive products.

From the aspect of horizontal FDI, the investors are more reluctant to allow technology transfer, due to the competition risk. At the vertical investments, the investors are very interested in creating solid network of suppliers from the host country where their facilities are located. While at first, they were requesting that their suppliers from the home country are following them in the new foreign markets, later, both the investors and their suppliers were looking for local providers of their material and production inputs at low cost, which, in turn, was creating opportunities for the host country firms as well.

1.6.1 FDI spillovers and externalities

In order to stimulate the growth of local suppliers to foreign subsidiaries, the host country government should ensure that they have the same benefits from the business-enabling environment as the foreign investors. Moran (2006, p. 43) argues that local enterprises, too, need stable macroeconomic framework, reliable infrastructure, stable regulatory environment, and low level of corruption, skilled workforce. The business-friendly environment should be followed by banking system that can provide competitive financing to local companies.

In horizontal direction, the spillovers and externalities could spread to the rival firms, while in the vertical direction they could extend to the suppliers in the backward linkages and to the buyers in the forward linkages. In their research, Javorcik and Spatareanu (2005, p. 3) found that there could be two overlapping horizontal impacts. On one hand, the foreign investor's entry is improving the local firms' performance through the spillover of

knowledge and trained personnel. At the same time, it damages local firms' outcome through the rising competitive pressures. Under such conditions, the local firms that are the least efficient would make lower profits, some of them might even exit that particular sector.

In vertical direction, the foreign investors could provide different forms of direct assistance, both to their local suppliers and distributors: advance payment, new technology and machinery, training of their personnel, re-organized production line, and improved quality control, introducing their local partners to other potential foreign customers. More distant and indirect externality from the FDI could be the striving of local companies to improve their performance in order to increase their chances in becoming a supplier to the foreign subsidiaries. It is not rare that the multinationals require from potential local suppliers to get an ISO 9000 certification for high quality standards in order to qualify.

1.6.2 Investment promotion to attract FDI

When the foreign investors were considered as an instrument for import-substituting growth, the state agencies responsible for FDI were simply waiting for foreign investors to show up and express their interest to invest in that country. The agency would present all the requirements that the interested investors should meet in order to get an approval.

Attracting foreign investors that would be export-oriented proved to be completely different game. MNEs are very risk-averse when they have to make a decision to invest in certain country, when such capital-intensive and long-term commitment would need to be successfully integrated into their supply chain, and which success would have an effect on the company's standing on the international markets. Even if their requests to be unconstrained from any requirements to incorporate any scale of input from the host country in their operations are met, MNEs are very careful to set up their subsidiaries in new and untested locations. These aspects completely changed the role of the host country agencies in charge for serving foreign investors. Instead of passively waiting for investors interested in profit making to knock on the door, these agencies have to be very proactive in demonstrating that their countries are superior places for investment compared to the alternative locations. This is even more challenging, since the investors would not be 100% sure about making right decision to invest in an uncharted territory until the investment is done and they tested the new location.

In order to attract FDI, host countries must **create an investment-friendly environment**; a tremendous, long-term and demanding task. According to the World Bank Doing Business Report (2016b, p. 34), some of the key measures to improve the business environment are:

• Ease of paying taxes;

- Concise regulations and simple bureaucratic processes;
- Reliable legal system that secures efficient implementation of the regulations (and especially contract enforcement); and
- Political will to endure in the reform efforts.

In addition, host countries must be able to **provide comprehensive information about the investment possibilities** in their economies. The foreign investors do not necessarily have comprehensive data on the alternative sites for production in different parts of the world. The host countries need to establish agencies for promoting investments that are equipped and staffed to promote the country, not just by creating and distributing glossy advertisements and booklets, but also by providing detailed information on different policy requirements and stimuli for investments that the corporate executives from developed countries would need to make decisions on their investments abroad. These agencies should be staffed with highly trained and motivated professionals, supported with welldesigned and informative website that provides up-to-date information on all legal and policy framework for investing in particular sectors of the host country economy, with links to the relevant officers in the related ministries. They should grow into an actual onestop-shop, which will have an authority to approve investment projects in efficient and transparent manner.

The investment promotion has a cumulative effect. A proactive and efficient investment promotion agency attracts the first investors and the developers of investment parks. Once the first investors come, it creates an opportunity for the developers to reach out to new investors through their networks in their home country. The existence of the established investors and their collaboration with the developers gives credibility and comfort to the following investors in these sectors, as well as to the pioneering investors in new sectors.

Another aspect of the strategy to attract FDI is to make an effort for **overcoming the anxiety of the potential investor**, who has to make a decision for making a large capital investment without knowing 100% in advance, whether the investment would work or would be a "lemon", similar to purchasing used car. To alleviate this anxiety, the host country is investing in infrastructure or providing vocational training for the personnel that will be hired in the foreign affiliates. This would help in reducing the ambiguity whether the investment, especially the first one in particular sector, would be successful or not.

The most questionable component of FDI attraction strategy is the **provision of tax breaks and subsidies** to the foreign investor. There are different positions on the real benefit from it. In some cases (Costa Rica, for example), the externalities and spillovers from the FDI compensate for the cost of lost tax revenues. However, there should be a consideration how to avoid "tax-free" wars among developing countries in their efforts to be more attractive than the others for the potential international investors. Therefore, some argue that developing countries would better spent their money for promoting FDI possibilities by improving the overall business environment, offering solid infrastructure and vocational training opportunities, functional rule of law and low incidence of corruption. Actually, the whole economy would benefit from these factors.

Some countries have established EPZs, free trade zones (hereinafter: FTZs) and industrial parks that are complementing the work of their promotional agencies. These parks and zones are managed by private developers, who are recruiting investors, usually from the same country of origin as the developers, who are willing to pay the fee to work in such zones and parks, getting in turn services offered by the developer in terms of the housing, security, transport, and other.

1.6.3 The treatment of the workforce

In order to attract FDI, developing countries might subdue to the pressure to promote lower labor standards and low labor costs, especially in the labor-intensive sectors (e.g., garments and footwear).

However, studies have shown that offering poor labor standards is not a magnet for attracting FDI (Aggarwal, 1996; Rodrik, 1996 in Moran, 2006, p. 71). On the contrary, countries with low labor standards experience lower FDI inflows in spite of the other attributes of the host countries. These findings do not support the arguments that host countries are pressured to lower their labor standards, and to expect substandard salaries and working conditions for their workforce in order to attract FDI, especially in the labor-intensive sectors. Furthermore, foreign investors whose operations are in more sophisticated and higher-end products sectors (e.g. electronics, auto parts, and medical devices) need to hire and keep superior workers if they want to keep up with the competition on the international markets. Consequently, they need to offer higher salaries than the ones in the less-skill-intensive sectors and to provide better working conditions.

1.6.4 FDI policy instruments

According to the United Nations Industrial Development Organization (hereinafter: UNIDO) (2003, p. viii), the FDI policy framework is the key portion of the national strategy for economic development of the developing countries. Naturally, MNEs play the crucial role in bringing the FDI in these countries. Consequently, in order to attract FDI, these countries need to create an investment-friendly landscape in their economies through the very considerate/attentive national policies. This is challenging, given the interests of both the host country government and the foreign investor, which not necessary always correspond or are on the same line. One of the primary concerns of the host country government is to increase the "welfare functions within the national economy for the

benefit of citizens" (UNIDO 2009, p. 2). On the other hand, MNEs are focused on "maximizing the long-term value of the firm for the benefit of the shareholders" (ibid.).

Hence, the policy instruments to attract FDI should, on one hand, be in line with the development strategy of the host country government, and at the same time promote and improve the environment for attracting FDI, especially those FDI that can deliver higher levels of value creation. One of the questions that should be addressed when shaping the FDI policy is whether it should be more liberal or more accented on regulations.

When making decision where to invest, MNEs are taking into consideration the conditions in the host and home countries and compare them with third locations in relation to the advantages of all these different locations. In addition, developing countries need to design their FDI policies in accordance with the set of rules and international laws imposed by the WTO, such as the Trade-Related Investment Measures (hereinafter: TRIMs), the General Agreement on Trade in Services (hereinafter: GATS), the Agreement on Subsidies and Countervailing Measures and Trade-Related Intellectual Property Rights (hereinafter: TRIPs) (WTO, 2015; UNIDO, 2009, p. 7). These rules and agreements stipulate that some investment measures should be eliminated, being discriminatory, limiting and distorting for the international trade. On the other hand, by promoting more favorable business environment, they reduce the barriers in the international investment and give an impression that they give preference to the MNEs and developed countries, whereas the bargaining position of the developing countries is more restrained. In addition, when designing their FDI policies, the developing countries need to consider the strategies and policies of the competing FDI locations.

Host country governments choose policy instruments - incentives that are in line with their general development goals. These instruments can be general or specific. In addition, they can be temporal or permanent. From the aspect of the geographic level, there can be instruments that are applied at a local or regional level, used to promote certain regions that are in need for investments; or instruments that are implemented at a national level, used to attract FDI for the whole economy or certain sectors/subsectors. At the firm level, these instruments can be for all FDI or only specific investors. All these different policy dimensions should be considered and applied in accordance with the host government's development goals. In applying and modifying the policy instruments towards achieving their development needs, host governments have to follow the dynamic changes in the MNEs activities.

According to UNIDO (2003, p. 22), incentives can be fiscal or non-fiscal. Fiscal incentives are: tax holidays, tax-free imports, tax exemptions. Non-fiscal incentives are: depreciation methods, Development Bank's loan policies, R&D support, environmental standards support, labor training support and government subsidies. Oman (2000, p. 26) points out
that the difference between the industrialized and developing countries is that, while the former are using financial incentives, like grants, the latter are using fiscal incentives, like lower corporate income tax, tax holidays and duty exemptions. However, the issues related to these incentives are multi-fold: for the host government they are opportunity cost of resources, the lack of transparency that creates an environment conducive for corruption and other rent-seeking practices, tendency to favor bigger corporate investors on the account of smaller ones, and foreign enterprises over local enterprises, which distorts the market. Furthermore, incentives have better effect in developed regions, in comparison to the less developed ones, where economic fundamentals play more important role (Svetličič, 2010, p. 5). FDI incentives are more appealing to the footloose FDI, unlike sustainable FDI that stay in certain location in long term.

1.6.5 FDI and regional integration

The regional integration agreements signed between two or more countries proved to be very effective tool to attract FDI. Such regional agreements are: the North American Free Trade Agreement (hereinafter: NAFTA), the so-called Mercosur Agreement in South America, the Association of South East Asian Nations (hereinafter: ASEAN), and the EU. They promote FDI not only by fostering more intra-regional investments, but also out of the region or agreement. In first place, these agreements create bigger markets. They also imply greater market deregulation in the member states, which makes them more attractive for FDI by the MNEs from outside. In addition, these agreements stimulate better cooperation among host governments in harmonizing their policy instruments and both, the fiscal and financial incentives. Consequently, the competition among their policies to offer more and more incentives that ultimately would have detrimental effects on all of their economies is decreasing. In a nutshell, these agreements help in attracting more investments and in improving the coordination among the governments of the member states.

1.6.6 FDI determinants

In their study on the FDI determinants in developing countries, Mottaleb and Kalirajan (2010, p. 1) conclude that countries that have bigger GDP, higher GDP growth rate, business friendlier environment and bigger proportion of international trade, have shown more success and better results in attracting FDI. Nevertheless, to determine the factors that influence the decision of the foreign investor to make FDI in certain host country is a challenging task. The host country determinants of FDI can be classified into three main categories: the national policy framework for FDI, the economic determinants, and the business facilitation measures (UNCTAD, 1998, p. 91).

1.6.6.1 National policy framework

The national FDI policy framework provides the rules and regulations related to the entry of foreign investors and their operations. The relevance of the FDI policy as determinant is evident from the simple fact that FDI cannot happen if it is not allowed to enter in the host country, or if the host country suddenly becomes more or less open. The range of these policies could be from total embargo of FDI on one end, to equal treatment of both domestic and foreign investment, to favored treatment of FDI in comparison to domestic investment, on the other end. While restrictive policies pretty much have predictable outcome – less FDI, FDI liberalization, although intended to encourage FDI, has unpredictable results. Open FDI policy invites MNEs to invest in the particular host country; however, it is not guaranteed whether the MNEs will be responsive to these encouragements. Open FDI policy, although one of the key determinants, is not sufficient as a stand-alone determinant. Other determinants have to be in place for FDI to flow into the host country too.

The increase in the offer of FDI locations was followed by the increased selectiveness and demands related to the other FDI determinants by the MNEs. Foreign investors are increasingly evaluating host countries as potential FDI locations through the lenses of their broader policy framework. Consequently, the liberalization policies become less effective locational determinant, which leads the host countries to focus their efforts in implementing measures that facilitate the business operations of the foreign investors and improve other FDI determinants. Their attention was drawn to the improvement of other economic policies that are not directly focused on FDI, such as the macroeconomic policies that affect the industries' structure, labor market or the educational and health policies. In order to be effective, FDI policies need to be coherent with this broader set of other policies.

1.6.6.2 Economic determinants

The economic determinants can be classified into three main categories, based on the main motives for FDI (UNCTAD, 1998, p. 91).

For the market-seeking FDI, the key economic determinants are: the market size and per capita income, the market growth, the country-specific consumer preferences, and the structure of the markets. The market-seeking FDI could be triggered as a way to overcome the barriers for entrance in certain markets in form of high tariffs and quotas that are imposed by the host country government to protect the domestic producers from the international competition. They are also known as "tariff-jumping" FDI (UNCTAD 1998, p. 107). The market-seeking FDI are also drawn to the countries that have access to the international markets, especially privileged access to the markets of developed countries

obtained through international agreements. If the access to these markets is limited by various barriers (tariff or non-tariff), the country is less attractive as a location, and that would divert MNEs to invest elsewhere.

For the resource/asset-seeking FDI, the key economic determinants are: the presence of raw materials, low-cost unskilled labor, skilled labor, technological, innovatory and other created assets, e.g. brand names, and physical infrastructure (ports, roads, power, and telecommunication). First, this type of FDI would be guided by the availability of the low-cost labor. However, given that numerous countries interested in attracting such FDI can offer cheap labor, they need to offer more than the other countries in terms of the quantity, but also quality – the level of skills of their labor. Furthermore, labor alone is not sufficient as determinant to attract resource-driven FDI in particular country; it must be accompanied with other advantages, such as a reliable infrastructure.

For the efficiency-seeking FDI, given that they are driven by the reduction in operating costs, the key determinants of FDI are: the cost and productivity of labor, other input costs, such as transport and communication costs to/from and within the host economy, and the costs of other intermediate products. Additional determinants are the facts whether the country is a member of regional integration agreement and conducive to the establishment of regional corporate networks. If the country losses its' competitive advantage, due to, for example, increase in the wages relative to the productivity, the MNE may decide to relocate its operations to other foreign locations that offer better conditions.

The traditional FDI determinants continue to be relevant, such as existence of natural resources for natural resource-seeking FDI. However, for a host country to continue being competitive in attracting FDI, possession of only one of the main determinants might not be sufficient any longer. More of a combination of the fundamental locational determinants, such as business enabling environment for efficient operations, high-quality resources, and access to other markets, could draw the attention of MNEs that are following a strategy for integrated international production strategies. The selection of location for the FDI will be done based on the best combination of the key locational determinants in terms of their contribution towards enhanced competitiveness of the MNE as a whole. The availability of educated and trained labor becomes an increasingly important determinant. However, losing the locational advantage due to the increase of labor cost does not necessary result in loss of FDI, despite the high mobility of such investment.

The increase of cost of labor might be a result of the economic restructuring that involves higher productivity and better skilled labor. In that case, the lower-grade FDI would be replaced by new higher-quality FDI, which happened with the labor-intensive industries in the newly industrializing countries in Asia (UNCTAD, 1994, p. 71). The membership in

regional integration platforms, such as NAFTA or EU, provides an additional locational advantage, which ensures durable access to the large markets of the developed countries - members of these platforms. However, the other economic determinants should also be favorable in order to benefit from these associations, resulting with increased FDI inflows in the labor-intensive industries. MNEs would avoid locating their operations in countries where there is a risk for losing the opportunity to operate internationally. They would give priority to countries, which economies are open and connected with the global market, with stable, transparent, and predictable business environment, and consistent policies that support the complementing relation between the FDI and trade.

1.6.6.3 Business facilitation

The growing competition among countries in attracting FDI forced them to introduce more proactive policies, not only in attracting FDI, but also in servicing FDI when brought. The policies directed towards attracting FDI include such measures as campaigns or special promotional events in targeted home countries; pursuing particular foreign investors that might positively respond to the promotion activities and invest; and servicing them after they made decision to invest, especially in dealing with bureaucratic hurdles in obtaining various permits. All these efforts have resulted in establishment of so-called "one-stop shops" in many developing and even developed countries. The aim of these organizations is to deal with all the issues related to the FDI projects. The after-investment services are important, since, it is not sufficient only to persuade foreign investors to invest, but also to stimulate them to re-invest the earnings from their investments back in the host country economy, thus benefiting further from this additional source of FDI. Furthermore, these services should preserve the current level of FDI and avert any potential divestment. In addition, the positive experience of foreign investors in particular country could be one of the best references in attracting other potential investors.

Another type of business facilitation measures is investment incentives. In their efforts to attract foreign investments, the host country governments are trying to convince them that their country is better location than other, competitive sites. In that line, they offer incentives in various forms, to attract them, and then to keep those investments in their country. When the foreign investments are made, the governments are offering incentives to boost deeper linkages and spillovers in the host economy, by stimulating foreign operations to hire local employees, subsiding their training and further education, or fostering cooperation with the local suppliers.

The investment incentives are used both, by the developed and developing countries. They can be costly. The most prevalent type is the tax incentives and grants, although the measures for technical and business support are equally important. Another form is the regulatory incentive, when the government provides special law treatment to the

investment. The incentives could be widely available to most of the players in particular industry sector or they could be more specific and focused, in terms of time and location, for achieving certain policy goal.

The "dark" side of the incentives is that they are at the expense of the tax revenues for the government, and that they are more likely to attract the so-called "footloose" investments, not the more long-term ones. Incentives benefit those companies that would have invested anyway. These companies are more concerned about the overall environment in the country, which is consisted of its political, social, and economic factors.

The disincentives can take shape of, e.g. a slow processing of creation authorizations, or prohibition to invest in specific sectors or regions of the host country. Agarwal (1980) finds that, while the incentives have limited effect on the FDI, since the investors are making their investment decisions based on the risk and return analyses, the disincentives may have more certain impact on the FDI.

There are many cases where the governments provide many incentives to attract greenfield investment, while they are more restrictive toward the acquisitions. The logic behind this is that the greenfield investments would influence the increase of the local capacity and the competition would become more intensive. However, many studies have shown that the incentives had minimal influence over the decisions about making certain investment, and again, it is tied to the business characteristics and the FDI motives. In general, MNEs that are looking into entering new markets or getting access to certain natural resources or strategic assets are not motivated to invest in certain location by the incentives in the first place. Unlike them, those companies that look for cost reduction of their operations definitely take into consideration the incentives offered by different locations abroad. In addition, the incentives can play important role in the decision-making when the investor needs to decide between locations with similar attractiveness and, furthermore, when they belong to one bigger market, like the EU or China.

In general, all companies want incentives that are transparent, easy to understand, and value the certainty in incentives policy (Johnson & Toledano, 2013, p. 17). Those incentives that do not meet these criteria will be less effective in influencing the decision about investing and the location. In addition, the incentives cannot compensate for other impediments or deficiencies, like the poor infrastructure, small market, corruption, or weak rule of law.

According to Johnson and Toledano (2013, p. 17), the FDI incentives can be categorized in four groups:

- Fiscal/tax incentives: these are concessions given out of the regular tax system. They can be in different forms: exemptions, allowances, credits, reduced tax rates, accelerated depreciation, duty exemptions, VAT exemptions.
- Financial incentives: cash grants for start-ups; soft loans; interest subsidies; loan guarantees; public property sold under the market values to the foreign investor; reduced prices for public utilities; subsidies for wages and job training; social security contributions exemptions, subsidies for R&D and innovations. There are also other non-fiscal incentives: exemptions from environmental norms and regulations; streamlined administrative procedures and assistance, support for relocation and expatriation.
- Regulatory incentives these incentives provide an opportunity for exemption from certain laws or regulations or their amendments. For example, there might be a clause in the investment regulation that, if there is a change in the regulation that is less favorable to the existing investment, the investment can be either excluded from that change or get compensated for the additional costs related to complying with that change. Other incentives of this type could be investment treaties and instruments that give the foreign investors rights and benefits that go beyond the ones already regulated with the existing legislation.
- Technical or business support incentives the purpose of these incentives is to reduce the information asymmetry and lessen the administrative burden for the investors. These activities are core of the investment promotion agencies. They focus on the dissemination of information on the opportunities for investment in the particular country and the related procedures, and offer services to the investors after they have already invested. These services might also include infrastructure and land provision at lower than the real market prices and other financial incentives.

The low-income countries are using more fiscal than non-fiscal incentives. This tendency is explained with the smaller impact on the budget from the missed tax revenue than the payments related to the financial incentives. These countries also tend to tailor the incentives to the individual FDI projects and offer them on case-by-case basis.

The effectiveness of the offering variety of investment incentives can be evaluated by analyzing both the costs and benefits from these incentives. That is rather complex and challenging undertaking. Nevertheless, the promotional measures, the incentives, and the other business facilitation measures do not have a key role as FDI determinants. They can only be supporting factors to the basic economic determinants of a particular country. The availability of human resources at competitive costs, well-developed transportation and communication infrastructure, a stable and open economy, and the widespread use of English (UNCTAD, 1994, p. 74) are some of these basic economic and other factors. In

absence of these factors, no promotional efforts or incentives can help in attracting substantial FDI. All these factors create an enabling investment environment that would be able to meet most of the investors' requirements. In order to become and remain competitive, the governments of the developing countries should not only promote their economies as great destinations for FDI, but they also have to constantly improve their policies in education, infrastructure or in supporting small and medium enterprises which might become suppliers to the foreign operations.

In summary, incentives as stand-alone factor are not sufficient for FDI to happen. However, when the foreign investor has to choose between two destinations that have almost identical investment environment, the presence of absence of these business facilitation measures could prevail in choosing the location for the FDI and can really make a difference, especially for countries that were previously unknown as FDI destinations to the MNEs.

1.6.6.4 The effect of the international agreements on FDI

Countries are entering into different types of international agreements – bilateral, regional, and multilateral, in order to influence FDI determinants and FDI flows, including the quality of inward FDI.

a) Bilateral investment treaties

Initially, the bilateral investment treaties (hereinafter: BITs) were agreed among developed and developing countries, to promote investing between the parties of the treaties. Over the years, these treaties are being signed between developing countries, and the countries in transition are becoming one of the signees. Although BITs cannot change the economic determinants of FDI, they positively influence the FDI environment. The impact that these treaties have on FDI is reflected in improved investment climate, better treatment and protection of the foreign investors, and introduction of mechanisms to resolve disputes. All these aspects contribute to reducing the risk of investing in the countries - signees of these treaties. However, there are examples of countries that demonstrate great results in attracting FDI although they have signed few or none BITs. On the other side, there are also examples of countries that are signees of many BITs but have achieved very humble results in FDI inflows. BITs are not significant FDI determinant, as is the case with market size, market growth, exchange rates, or country risk (UNCTAD, 1998, p. 117).

b) Regional integration frameworks

The regional integration frameworks (hereinafter: RIFs) can range from free-trade agreements to agreements for full economic integration. Their impact on the FDI

determinants depends on the level of integration envisioned with the RIFs, which also affects the degree of policy harmonization. If the RIF entails only tariff reductions among the members and imposing tariffs for non-members, that RIF could affect FDI determinants through trade. If RIF involves capital movement among members, it would be expected to impact FDI determinants beyond the trade liberalization. As the region becomes more integrated due to the RIF, the MNEs are giving more weight to the economic FDI determinants when choosing the location. RIFs, such as EU and NAFTA, proved to have a significant impact on the FDI flows and growth in the respected regions. However, certain member countries may choose to be exempted from the RIF's stipulations and to continue with access restriction to some strategic industries or keep high import tariffs for certain products. These exemptions could also have an impact on the FDI determinants.

1.6.6.5 The importance of the absorptive capacity of the host country

While the foreign investors in principal get returns from their FDI, (otherwise they would not engage in it), the benefits from the FDI are not given to the host countries. Nguyen et al (2009, p. 1) argue that whether the FDI benefits will translate into host country's spillovers depends on its' absorption capacity. It is not sufficient only to attract FDI; the host country should attain certain circumstances to be able to absorb the benefits from FDI inflows. According to Nunnemkamp (2002, p. 42), the host countries should reach certain level of development in order to reap the benefits from FDI. Otherwise, their high expectations would be unrealistic.

Nevertheless, the expectations of the host countries about the expected benefits from FDI are generally expressed through anticipated capital inflow and FDI contribution to the GDP growth rate, jobs creation and increased employment, transfer of upgraded technology and technical skills. The level of successful transformation of these externalities into internalities of the host country depends on its absorptive capacity. It not only affects the economic growth of the host country, but also has an impact on attracting more FDI inflows, both in quantity and in quality. Consequently, the absorptive capacity is more important factor than the attractiveness for FDI.

Absorptive capacity is the capability of the economy to congregate new technologies innovated elsewhere, and to integrate them into the production processes (Christl, 2007, p. 55). The quality of the human capital in the country is the key factor of its absorptive capacity. There are two stages of absorptive capacity: firstly, to bring FDI projects to actual implementation in the country, and secondly, to transform the benefits from their operations in the host country into its competences (Ngyen et al, 2009, p. 5).

The absorptive capacity of the host country could be analyzed at two levels: the absorptive

capacity of the domestic enterprises, and the absorptive capacity at the national economy level. Building the necessary social capabilities and absorptive capacities, so that domestic enterprises can benefit from the technology spillovers from MNEs, becomes a growing challenge for the host countries. Therefore, R&D and innovations play very important role in increasing of the absorptive capacity of domestic enterprises, in terms of being able to identify, embrace, and use the outside knowledge – the so-called learning or absorptive effect (Damijan et al, 2003a, p. 5).

With reference the domestic enterprises' capabilities, Cohen and Levinthal (1990) indicate that domestic enterprises need to possess certain body of prior knowledge in order to be able to evaluate and commercially exploit new external knowledge, such as new scientific developments and technology innovations, into their operations. The prior knowledge translates into the ability of the enterprise to recognize the value and importance of certain new developments in the field of their interest, and then absorb and apply those developments in their work. In addition, that represents in essence the absorptive capacity of the enterprise.

Foreign investors would cooperate with the local enterprises, as partners, sub-contractors or suppliers. Depending on how advanced is its technology, how qualified are its workers, and how skilled is its management, local enterprise could learn from the contacts with the foreign enterprise and absorb the more developed technology and advanced managerial skills from it. As a consequence, the exposure to and assimilation of the more advanced technology would have positive impact on the productivity of the local enterprise, which in turn, becomes one advantageous factor in competition. In addition, as supplier to a foreign enterprise, the local supplier needs to meet its requirements in terms of the quality of delivered goods or provided services. However, that also depends on how committed the foreign affiliate is in working in the host country.

With reference to the workforce, if the **labor** is better educated and skilled, it will better absorb the knowledge transferred from foreign affiliates, which will ultimately be reflected in better performance. Borensztein et al (1998, p. 115) argue that "the higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital." The availability of skilled workforce is important, because it would be better capable of learning and creating new innovative ideas and adapting them in their operations. In turn, the low educated and skilled workforce impact the disbursements of the investment and give less favorable image of the host country as FDI destination, especially in capital-intensive industries/sectors, where the availability of good quality workforce is among the driving forces in attracting FDI.

The **financial system** is the linchpin that facilitates the realization of the FDI projects in the host country. In order to be able to implement FDI-related activities, the foreign

investor would need a financial system that would enable him/her to transfer the initial capital from its home country or other foreign affiliates; to make payments related to the production inputs; to be able to charge for the delivered products/services, or to transfer the income generated from this operation to other foreign destinations.

The **physical infrastructure** represents the complex of basic physical structures necessary for normal functioning of the economy, such as the systems of energy and water supply, transportation and telecommunication networks, as well as sanitation and waste disposal structures. The physical infrastructure is one of the development pillars important not only for foreign affiliates but for the local enterprises and the economy of the country as a whole. They need reliable roads, railway, water roads, and airlines in order to be able to transport the production inputs and deliver their products to their clients. Otherwise, the bad condition of the transportation infrastructure would negatively affect the efficiency and it would increase the costs of production. That would ultimately bring less profit for both, the foreign investors and the host economy. Furthermore, with the development of the information and communication operations through telephone and internet, the presence of well-dispersed and stable ICT network becomes more and more important determinant of FDI.

In order to benefit from the advance **technology** that might be brought with the FDI inflow, the host country needs to have some initial technological development. In other words, another factor that determines the absorptive capacity of the host country is the technology gap between that country and the country from where FDI originates. The results of the research by Borensztein et al. (1998, p. 126), which examined the FDI effects on economic development and the channels through which FDI could be beneficial for growth, reaffirms that the impact of FDI's advanced technology on the growth rate of the host country's economy depends on that country's absorptive capability. In that line, one of the factors of the absorptive capacity is also the level of **R&D**. When the level of development of the R&D is higher, the absorption of an advanced technology brought through FDI is easier, too.

The **institutional factors**, presented through the framework of the regulations and administrative institutions that support the FDI operations, also influences the absorptive capacity of the host country. The protection of the property rights and clear and stable regulations encourage the foreign investors to enter the economy and further expand the FDI. In contrast, the risk of the property nationalization or complicated and ever-changing regulations may guide the foreign investor towards relocating its investment to another country.

1.6.6.6 The impact of the institutions and the social capital on FDI

Bénassy-Quéré, Coupet and Mayer (2005, p. 8) argue that the "efficient protection of civil and property rights, extended economic and political freedom and low level of corruption have been in particular shown to be associated with higher prosperity". For the developing countries, FDI are being considered as one of the most stable factor of capital flows, and they can contribute to the technological progress by introducing and dispersing the more advanced production techniques in the host country. Hence, how can good institutions influence the FDI inflows in the host country?

Good governance frame positively affects the productivity, while the prospects for increased productivity may attract FDI. In contrast, poor institutions imply inefficient, non-transparent, and corruptive practices that increase the costs to FDI. In addition, FDI are exposed to the high sunk costs, which makes them very sensitive to the weak rule of law, especially in the area of the protection of the property rights, complicated and frequently changed policies, and other forms of uncertainties.

Countries with improved institutions and bigger FDI inflows (such as Poland and Romania) are characterized with higher capital intensity of foreign enterprises and lower labor intensity of local enterprises. In contrast, the countries with worse institutions and smaller FDI inflows (such as Russia) are characterized with lower capital intensity of foreign enterprises and higher labor intensity of local enterprises (Tytell & Yudaeva, 2007, p. 84). Part of that is consequence of the hesitancy of foreign enterprises to outsource to their local suppliers anything else except the production of simple and labor-intensive components of their production processes. The public efficiency, reflected through the tax system, how easy is to register company, transparency and the absence of corruption, efficient rule of law and effective protection of property rights, is one of the major determinants of FDI (Bénassy-Quéré, Coupet & Mayer, 2005, p. 28). Consequently, developing countries should make efforts to improve their institutions and make them closer to the institutions of the source countries in terms of their quality, which may help them in attracting more FDI.

On the other hand, the developed countries cannot differentiate from the others based on how their institutions are designed, since they can be copied by the other countries. What makes them different from the others is the role and position of the civil society, and the core norms and values built in the institutions. The informal norms and values, like trust, ethic, accountability, guilt, shame, that dominate in a society play an important role in the progress of that society, because they impact the way of functioning of different institutions. The concept of so-called social capital represents a measure of the quality of the informal institutions in certain society (Dunning & Lundan, 2008, p. 304). The civic engagement in different forms and the existence of belief systems, especially trust, are among the key factors that contribute to the creation of social capital. The presence of the trust facilitates the exchange by lowering the transaction costs among the economic subjects. The correlation between the social capital and economic development is positive in those countries where the level of education is higher and the other democratic institutions controlling the power of the executive are strong (Dunning & Lundan, 2008, p. 306). The quality education system contributes not only to the growth of the human capital; it also contributes to upgrading of the social capital in the society. The countries with high social capital are characterized by transparent and reliable good governance, which makes them more attractive as location for business. Rose-Ackerman (in Dunning & Lundan, 2008, p. 308) elaborates that the low-level corruption goes together with transparent and accountable government; and where honest dealing is highly valued and respected, there is a strong confidence among the people that any breach of trust will be sanctioned and they do report any unlawful activity. That trust among the people is conveyed to trusting the public institutions in their fairness and objectivity, which on the other hand, relaxes the pressure on the institutions to keep robust enforcement systems. In contrast, countries with high level of corruption and ever-changing policies tend to have bigger challenges in achieving economic growth (Dunning & Lundan, 2008, p. 338).

In fact, MNEs, with exception of their business operations in sectors that are exploiting the natural resources, mostly allocate their operations in environments with strong good governance. Therefore, for the developing countries, the improvement of their institutions, education systems, and technological potential is essential in order to benefit from FDI (Glaeser et al., 2004, in Dunning & Lundan, 2008, p. 338).

2 FDI AND EMPLOYMENT – THE CASE OF MACEDONIA

Macedonia is a landlocked country with an open economy and a small market of less than two million inhabitants. Since 1991, when the country proclaimed independence, Macedonia remains an economy in transition. Like with other transition economies, Macedonia had to deal with stark immediate challenges and enduring limitations on development: growing unemployment, increasing inflation, lack of entrepreneurial mentality, neglected infrastructure, corruption, and ineffective rule of law.

Furthermore, the disintegration of former Yugoslavia, for Macedonia, whose economy was structured to be a source of raw materials for the industries located in the other Yugoslav republics, caused loss of the most important market of its output. In addition, it resulted with loss of almost 50% of its supply and import channels (Kikerkova, 1997, p. 111). Simultaneously, the collapse of the Council for Mutual Economic Assistance (hereinafter:

COMECON) resulted with the loss of the traditional clients of the Macedonian production. To make things worse, the country suffered enormous losses due to the embargo imposed to the federation of Serbia and Montenegro by the United Nations on the northern border, and the embargo that Greece imposed on Macedonia due to the name issue on the southern one. Many production facilities collapsed or reduced their production, which resulted with additional cuts in jobs and increased unemployment.

The transition process, the loss of the traditional markets, and the economic embargoes caused recession. The overall production, GDP and the gross fixed capital formation rapidly fell at 50% of their 1989 levels (Kikerkova, 1997, p. 112).



Figure 1: Real Growth Rates of GDP in Macedonia 1993-2015 (%)

Source: National Bank of the R. Macedonia Database, Basic economic indicators, 1993 - 2015.

The GDP plummeted. In 1993, it had a negative growth rate of -7.5% (Figure 1). The negative trend continued in 1994 and 1995, although to a lesser degree (-1.8% and -1.1%, respectively). Since 1996, the country was achieving rising growth rate, which soared from 1.2% in 1996 to 4.5% in 2000. However, the armed conflict in 2001 had a devastating effect on the growth, and the GDP fell at -3.1%. Starting from 2002, the country succeeded in achieving growth rates, which in the period from 2004 through 2008 were at the level higher than 4.5%. The global economic crisis that erupted in 2009 also had a negative effect on the GDP growth, which fell to -0.4%. The economy recuperated in 2010, achieving a growth rate of 3.4%. Following a negative growth rate of -0.5% in 2012, the country achieves growth rates in the coming years, with the highest rate in 2015 in the past 7 years, 3.7%.

2.1 FDI in Macedonia – The Economic Context

Macedonia had to cope with several fronts – to achieve macro-economic stability, to implement market reforms, and to restructure the economy through the privatization process. The high unemployment rate, which consistently remained over 25 percent since independence also reflected the harsh economic adversities. As other developing countries, Macedonia was strongly interested in attracting FDI, given the possible impact they can have on accelerating the transformation and economic growth, and especially on the persistently high unemployment as one of the biggest economic problems in the country. FDI are essential for financing the economic growth and improving the access to technologies (De Schutter et al. 2013, p. 1). In its analysis of the Macedonian economy, IMF had pointed out that FDI are the key factor to the growth of the Macedonian economy, especially in the years of global financial crisis (Kapital special report 2012, p. 9). The country initiated economy reforms and opened it for foreign investment.



Figure 2: FDI in Macedonia 1997-2015 (in million USD)

Source: National Bank of the R. Macedonia Database, FDI in Macedonia 1997-2015, External statistics.

Since 1991, the FDI inflows were modest through 1998. In the period 1998 – 2007, the FDI inflows were mostly growing, because of the privatization of the state-owned enterprises (Figure 2). In that period, foreign investors also acquired the key enterprises and banks. The peak of \$447 million in inflows in 2001 was mainly due to the acquisition of the national telecommunications operator by Magyar Telecom, an affiliate to Deutsche Telekom from Hungary. The drastic drop of inflows in 2002 and 2003 was mostly a consequence from the political instability in the country caused by the armed conflict in 2001. The highest peak was achieved in 2007, when the FDI inflows amounted to \$700

million. However, the global economic crisis and the debt crisis in the euro zone had a negative impact on the FDI in Macedonia. The FDI inflows dropped from \$473 million in 2011 to \$139 million in 2012. The main reason for it was the outflow of profits of the foreign affiliates and the intercompany loans. As the global economy recovered, the FDI increased to \$334.7 million in 2013. The increase was related to the new FDI projects in the FTZs and the additional investments by the existing foreign investors. The biggest part of FDI was made in the automotive parts industry, and the most of the foreign trade, both in export and import, was related to the operations in the FTZs. In the following years, the FDI inflows had decreasing trend, dropping to the low \$178 million in 2015.

Being a small country and market, Macedonia is oriented towards the international economy and has relatively open market for export and import. As such, the country is sensitive to the shocks in the international economy, and the global economic crisis from 2008 has demonstrated that.

There is a high correlation between trade and FDI flows. According to UNCTAD (2012a, p. 23), foreign affiliates export close to 60 percent of their output, whereas domestic enterprises export close to 40 percent. Hence, the significant impact that FDI have on the trade structure through its diversification, destinations, and increase of the overall export.

As of June 2016, the trade deficit increased by 23.4 percent year-on-year to \$183.9 million (Trading Economics, 2016). The high trade deficit can be partially justified with the significant import of goods that are key for the growth of the economy, such as petrol, electric power, iron and steel, transportation vehicles and fabric yarn.

In 2015, the value of Macedonia export was \$4.49 billion, while the value of the import was \$6.4 billion, which resulted with the negative trade balance of \$1.91 billion (National Bank of Macedonia statistics, 2016). The GDP in 2014 amounted to \$11.3 billion, while the GDP per capita was \$13,500 (MIT Media Lab, n.d.). Most of the export is concentrated in iron, steel, textiles, food, beverages, and tobacco. As of 2013, the most important trade partners, based on the volume of trade realized, are the countries from Europe – Germany, Bulgaria, Italy, Serbia, and Greece as top export destinations, and adding Turkey, Great Britain and China to these countries among the top import origin countries. The dominant portion of the 2013 export (24%) is led by manufactured goods classified by material; followed by chemical products which represent 19.5% of the total export and by miscellaneous manufactured articles (19.2%). The manufactured goods classified by material also lead on the import side with 30.8% of the total import, followed by machinery and transport equipment, which account for 17.5%, mineral fuels and lubricants (16.2%), and chemical products (13.2%) (National Bank of Macedonia statistics, 2016). The most exported products are catalysts with precious metal or precious metal compounds as the active substance, ferronickel, iron and steel products (flat-rolled products), clothes, and petroleum oil preparations, while the most imported products are crude oil, platinum and platinum alloys, motor vehicles and electricity (Trading Economics, 2016).

2.2 Structure of the Economy and Employment

After more than 20 years of independence, the Macedonian economy is dominated by the service sector, accounting for two thirds of the GDP (Figure 3), followed by the mining and manufacturing sector and the agricultural sector.





Source: State Statistical Office of the Republic of Macedonia, *Gross domestic product per sectors 2011 – 2013* Table T-PO1.

These structural changes resulted with the growth of the employment in the services sector from 39 percent in 2002 to 49 percent in 2012 (Figure 4). In the industry sector, the employment remained with some fluctuations in the proximity of 18-20 percent, while the employment in the agricultural sector declined from 29 percent in 2002 to 24 percent in 2012.



Figure 4: Total Employment per Sectors 2001 – 2013 (%)

Source: State Statistical Office of the Republic of Macedonia, *Total employment per sectors 2001 – 2013*, MakStat Database.

2.3 FDI in Macedonia - the Legal Context

The Constitution of the Republic of Macedonia warrants equal position of all subjects on the market and free flow of capital. All of the foreign investors are given national treatment, and they are allowed to establish and run private or joint stock enterprises of any type. Both, domestic and foreign investors have equal opportunity to take part in the privatization process of the state-owned enterprises and bid on their shares. The foreign investments are regulated through several laws. However, they are regularly changed and in that process, the business community, with its concerns as well as interest, is not being consulted (U.S. Department of State, 2016, p. 16).

According to the Foreign Loan Relations Law, foreign investors can transform their claims to the debtor of the bank into deposits, shares, or equity. In addition, this law allows the rescheduled debt to be transformed into foreign investment on the secondary capital markets or in certain sectors. Foreign investors can also repatriate profits and funds earned from selling shares after paying regular taxes and social contributions (Law on Foreign Exchange Operations). This law also permits foreign investors to choose the form of

reimbursement that they prefer. Foreign nationals can own land in Macedonia and they can invest in real estate and fixed assets.

Corporate profit tax is 10 percent. Since 2006, the government introduced a 15 percent retention tax on number of incomes of the foreign legal entities. The types of incomes that are subject of this retention tax are listed in the amended Profit Tax Law, and include, among others, dividend, interest, consulting and research services, lease, insurance premiums, author fees and other. This retention or withholding tax is not applicable to the legal entities based in countries with which Macedonia has signed an agreement for avoiding double taxation.

There are few sectors limited by law for foreign investment. The foreign investors need to get government approval to invest in the weapons or narcotics industries. They also need to obtain license, same as domestic investors, to invest in the sectors of insurance, banking, and financial services. Foreign investors are in privileged position in comparison to domestic ones, in terms of their right to full reimbursement for their investment in case of nationalization, which is not applicable to the domestic investors.

The government agency Invest Macedonia is doing the screening and due diligence review of FDI, in order to evaluate the economic benefit for the country and national security, while the government gives the final approval of the incentive packages.

The Macedonian national currency, the Denar (MKD) is pegged to the Euro, which keeps successfully its long-term stability and the inflationary fluctuations low. The Denar is convertible in Macedonia, but not on the foreign exchange markets.

The government offers a number of incentives for foreign investors in its efforts to attract FDI, especially in the Technological Investment Development Zones (hereinafter: TIDZs).

Macedonia became a member of the WTO in 2003 and abides the TRIMs Agreement, which banned the introduction and practicing of policies for promoting the interests of the domestic industries through local content requirements or trade balancing.

Macedonia had signed three multilateral Free Trade Agreements: Stabilization and Association Agreement with EU; European Free Trade Agreement (hereinafter: EFTA) with Liechtenstein, Switzerland, Iceland, and Norway; and the Central European Free Trade Agreement (hereinafter: CEFTA) with Albania, Bosnia and Herzegovina, Croatia, Kosovo, Moldova, Montenegro, and Serbia. In addition, Macedonia has bilateral free trade agreements with Turkey and Ukraine, and is a signatory of special Agreement for Promotion and Protection of FDI with 32 countries.

In terms of the protection of property rights, the U.S. Department of State Investment Climate Statement for 2016 highlights as an impediment for the business and investment environment the centralized control of the construction land owned by the government, uncoordinated local and regional zoning plans, and lack of efficient system for issuing construction permits. There has been a significant progress in the cadaster system that contributed to a more expeditious and secure real estate transactions. Nevertheless, there are still a significant number of disputes on property ownership-related issues that are not being resolved in a prolonged period. With reference to the protection of the other property rights, the protection of intellectual property rights and the prevention of selling counterfeit goods on the Macedonian market remain to be a challenge.

Despite the fact that Macedonia has a solid legal framework to fight corruption, the perception of the public is that there is a lack of political will to prosecute against corruption. The States Commission for Prevention of Corruption that was established in 2002 is passive and it brought very few cases for further investigation in front of the Public Prosecutor's Office.

The labor market in Macedonia is regulated with the Labor Law and collective agreements. In comparison to the other countries in the region, the labor regime is relatively liberal in flexibility of employment, in terms of working hours or the regulation of the redundant workforce.

However, the labor market for the foreign workers is restrictive. If the foreigners are visiting Macedonia for tourism or business purposes for a short period (up to 90 days), they need to obtain a short-stay visa at the diplomatic outposts of Macedonia. If they would stay in Macedonia for a period longer than 90 days, they would need a long-stay visa and temporary residence permit, and in addition, they would need a work permit, which is renewable on annual basis.

The restrictive permits framework is demotivating for employers to seek foreign skills; while the request to renew the work permits on annual basis makes the employees unsure about the stability of their permits. Another request that complicates the procedure to obtain work permit is that the applicants must personally submit the applications at the diplomatic posts of Macedonia in their home country. This requirement is not practical, especially for the MNE personnel that is already engaged in other foreign affiliates of the MNE.

2.4 The Economic Strategy to Attract FDI

In order to keep the growth rates higher, the levels of investments, both domestic and foreign, need to increase. Since 2001, the government had implemented many measures to

improve the business environment, including the legal and economic environment for the investors.

One of the identified deficiencies was the disproportionate bureaucratic "red tape" that is conducive for inefficient and corrupt practices (U.S. Department of State, 2016, p. 7). In 2006, the government initiated a legislative reform by eliminating over 50 percent of the administrative procedures through the so-called "regulatory guillotine" process. Nevertheless, the extensive and complex administrative procedures, as well as the unclear division of authorities and responsibilities among the government institutions, remain to be the most common complaints by the business community, both domestic and foreign-owned enterprises. In addition, although Macedonia has harmonized the most of its legislation with the EU, its implementation continues to be weak.

Although the government achieved noticeable progress in improving the business climate, and the country is ranked 12 out of 189 countries according to the Doing Business Report (World Bank, 2016b, p. 5), the investment inflows remain lower in comparison to the other countries in the region. With reference to the stock of inward FDI, Macedonia is at the bottom in the region, almost at the same level as Kosovo. All the other countries, including Montenegro and Bosnia and Herzegovina, have higher FDI inflows in comparison (Figure 5).



Figure 5: FDI Net Inflows 2006-2015 (BoP, Current USD)

Source: World Bank - World development indicators, FDI net inflows 2006-2015.

In 2007, the government initiated a wide range of measures to promote Macedonia as attractive FDI destination and to offer a variety of incentives for foreign investors. The government enacted a campaign to promote Macedonia as an investment "heaven". The campaign involves ads in the leading international newspapers and magazines, promotional spots in the TV stations with worldwide coverage, such as CNN, complemented with road shows in the home countries of the potential investors. Invest Macedonia is a government agency that promotes Macedonia as attractive FDI destination for foreign investors and serves as a main point for contact and dissemination of information, as well as for providing support to the investors. The agency has allocated 30 economic promoters in the key markets to promote Macedonia as attractive FDI destination to the targeted investors. Sectors that are promoted are: automotive and ground transportation, ICT, pharmaceuticals, textiles and apparel industry, agribusiness and food processing and packaging sectors.

In the same year, the government introduced the model of the TIDZs, which focus is on attracting and supporting high-tech enterprises. The government offers to both, potential and present investors, sites with physical and legal infrastructure, supporting services and incentives, such as tax, customs and other exemptions. Although, the Law on Technological Industrial Development Zones allows both foreign and local enterprises that are export-oriented to enter in these zones, so far, mostly foreign investors are operating within the existing TIDZs. The only Macedonian enterprise that will invest in the TIDZ in Skopje is Hi-Tech from Orešani. The company plans to invest \$20 million in producing software for the automotive, aircraft and marine industries, and rockets in 2016, hiring 100 employees at the beginning, with a plan to employ 300 workers (Utrinski Vesnik, 2016).

The Directorate for Technological Industrial Development Zones is in charge of developing, founding and supervising the functioning of the TIDZs. Currently, there are five major and ten smaller TIDZs. Three of the five major TIDZs are located in Skopje area (Skopje 1 – Bunardzik, Skopje 2 and Skopje 3), and the other two major TIDZs are located in Štip in the East and in Tetovo in the Northwest. The other TIDZs are located in Kičevo, Struga, Prilep, Gevgelija, Strumica, Radoviš, Delčevo, Vinica, Berovo, and Rankovce (Invest Macedonia, 2016).

In order to attract investors to open their operation in the TIDZs, the government offers a wide range of benefits:

- Exemption from profit taxes in the first 10 years of operation in the zone;
- Exemption from personal income tax in the first 10 years of operation in the zone;
- VAT and customs duty free import of inputs for products that are re-exported and for services used in the zones, which are directly related to these imported inputs;
- Attractive rate for leasing the land for up to 99 years;

- Release from paying municipal fees related to the preparation of construction land;
- Subsidies for building costs, that can range up to EUR 500,000; dependent on the number of new employments and the volume of investment;
- Subsidies for training (both, general and tailor-made) of the employees hired in the enterprises located in the TIDZs, in range of up to EUR 250,000;
- Free connection to and exemption from taxes on utilities (electricity, natural gas, water and sewage);
- Introduction of "Green Customs Channel" for streamlined customs clearance;
- State aid grant for initial investment in capital or intangible assets, such as patents, licenses, knowledge, etc. (Invest Macedonia, 2016).

If we analyze the type of FDI that have been initiated in Macedonia in the past several years, most of them were allocated in the TIDZs and in the manufacturing sectors.



Figure 6: FDI in Macedonia per Sectors 2001-2014 (in million EUR)

Source: National Bank of the R. Macedonia Database, *FDI in Macedonia per sectors 2001-2014*, External statistics, 2001 - 2014.

Since 2001, the FDI were disbursed relatively evenly between the mining and manufacturing sector on one side, and the services and other sectors on the other (Figure 6). After 2009, the FDI have been gradually moving from services to industrial products, and in that category, there have been shifting from traditional sectors (food and metal processing) into technology-intensive industries, especially in the automotive components, whose producers in Macedonia are also becoming its' main exporters. This change in the structure of greenfield FDI is linked to the fact that Macedonia can offer cost advantages compared to the other countries in the region, such as the low labor costs, the incentives offered to the foreign investors, the improved business climate, but also the duty free access to the European market, as well as the proximity of the country to the assembly operations in Turkey and Central and Western Europe (IMF, 2015, p. 11). Other sectors

that are attracting FDI are the construction materials, residential construction, food processing, or glass for packaging.

The accent of the policy is on attracting export-oriented FDI. The exports have an impact not only on the balance of payments, but also on the economic growth and employment. The export increase can positively influence the growth in employment. In order to increase the revenues from export, the economy should reallocate the resources in sectors that are more productive, but also that produce outputs of higher quality and value. Most of the export jobs by tradition are in the manufacturing industries, although in the coming period, the increase of the export generated in the service sector should be expected as well. Given the challenges that Macedonia is dealing with in these areas, the exports are essential for the economy.



Figure 7: Export per Sectors (in 000 \$)

Source: State Statistical Office of the Republic of Macedonia, Export per sectors, MakStat Database.

The mining and manufacturing sectors are the key generators of the exports in Macedonia, providing in average 94-95% of the total exports of Macedonia (Figure 7). In comparison, the exports generated from the agriculture sector are in the range of 4-5%, while the services sector generates only 0.1-0.2% of the total exports in average.

In order to better address the investment challenges and issues in Macedonia, the Foreign Investors Council (hereinafter: FIC) was established by the Economic Chamber of Macedonia in 2006. It plays an advisory role and provides suggestions to the bodies of the Chamber in their discussions with the authorities for improving the investment environment in Macedonia. Furthermore, the council proposes various reform measures, promotes the communication and flow of information between the foreign investors and the Macedonian authorities, as well as fosters the linkages with other foreign investor networks to exchange experiences and share best practices.

In May 2016, the Council published the findings of the latest survey conveyed among its members (118 in total) with reference to the investment and business environment in Macedonia. The overarching finding from the survey is that the foreign investors are satisfied with the overall business and investment climate in Macedonia. Dominant portion - 84% of the surveyed foreign investors would decide to invest again in Macedonia. Among the five most important factors for investing in Macedonia, the qualified workforce and cost competitiveness takes the lead by far in comparison to the other factors -45%. Indeed, one of the key FDI determinants in Macedonia, according to Minister Samak, is the 20-50% cheaper workforce (Kapital, 2012, p. 13). The low tax rates come in second place with 25%, while the legal predictability and the stable business climate come in third place with 12%. The location factor – proximity to the EU countries is ranked fourth with 10%, and the political and macroeconomic stability come last with 8%. On the other hand, 68% of the surveyed investors have been caught by surprise by the abrupt and significant changes in the legislation, which has had and is continuing to have an impact on their businesses. In addition, 60% of them stated that the business climate in Macedonia is not predictable. With reference to the cost competitiveness and the qualified workforce, 84% of the surveyed investors agreed that Macedonia provides cost competitiveness, and 76% of them confirmed that it provides qualified workforce. They think that there is still room for improvement in the efforts against the grey economy -56% of them evaluated the measures against it as "moderate". They are also complaining about the inspections and taxation and penalty policies -52% of them are not satisfied from the predictability, consistency and the fairness of the inspections, while 56% of the surveyed were also unsatisfied from the rationality and the fairness of the taxation and penalty policies (FIC, 2016).

In January 2016, the Center for Economic Analyses from Skopje (2016, p. 2) published their analysis of the costs and benefits for the state support to the FDI in TIDZs in the period 2007-2014. Some of the highlighted key findings are:

- There is lack of data on the costs for subsidizing FDI in TIDZs, and the nontransparency of the state aid makes the country incompliant with the EU regulations;
- The state aid offered to the investors in TIDZs does play a significant role in making decision to invest in Macedonia; and the sustainability of their investments, once the tax

exemption period ends, is questionable. If the government would stop with subsidies, only 3 out of 7 enterprises in the TIDZs would work with profit;

• Although the average net salaries of the employees are approximately at the national average, this is not the case with most of the companies.

2.5 The Labor Market in Macedonia

Some of the key reasons for the persistently high unemployment rate in the transition period in Macedonia are: (1) the loss of traditional markets; (2) the slow transition process that failed to create new jobs opportunities; (3) the demographic pressures; and (4) the large informal economy (Pejkovski, 2012, p. 64). The economic embargoes in the early 1990s, as well as the internal conflict in 2001, further deteriorated the situation.

Being a country in transition, Macedonia was affected by a comprehensive structural change characterized by the privatization process and restructuring of the enterprises, which resulted in job losses in the state- and socially-owned enterprises on large scale, and made the skills from the former system outdated.

Older workers with these obsolete skills became especially vulnerable to the long-term unemployment. Consequently, skilled workers who could not find job in the formal sector would take jobs that were paid low in the informal economy below their skill level, leading to the "over education" phenomenon.

On the demand side, while the old big industries were declining or closing down, the service industries were showing increase in creating new jobs where diverse new skills were required. In addition, the FDI were considered as resource that will bring new technologies and skills, as well as new management and working practices that would require "soft" skills, such as entrepreneurial attitude, teamwork, and communication. The lack of these skills indicates to the mismatch between the offered skills on the supply side and skills being required on the demand side of the labor market.

Arandarenko and Bartlett (2012, p. 6) list some of the reasons for this phenomenon:

- Old skills became redundant as the new technologies were introduced and the long-term unemployment became persistent;
- Employers were reluctant to invest in on-the-job training due to the instability caused by the poor investment climate; and
- The scarcity of adult education and opportunities for life-long learning hampered the prospects for re-qualifying for new skills.

Among other reasons for the lack of skilled labor, Sondergaard and Murthi (2012, p. 2) indicate at the quality of the education provided in the transition countries. In general, the lack of systematic data about how many students are learning and whether they are finding jobs after graduation is one of the challenges for improving the quality of education. In addition, the curricula are not tailored to the developing trends of the market economy and to the new occupations in the emerging sectors (service and high technology). The vocational schools are teaching skills specific for obsolete occupations, and the education methods are focused on repetition learning instead of problem solving methods.

Despite the fact that more than 60,000 jobs were created in the period 2007-2011, Macedonia still has among the lowest employment rates in Europe, with around 25 percent of active population unemployed. The jobs are predominantly with low-productivity, which means lower earnings, and there is still no change in their structure towards jobs with higher productivity. Among the newly created jobs, two out of three were in the informal sector, predominantly in the agriculture (60%) and retail trade (13%), while the rest of the new jobs were mostly created in the public sector, where salaries are high and growing. That moment raises concerns about the fiscal sustainability and the potential crowding out of the job creation in the private sector (World Bank, 2014, p. 2 and 8).

On the other hand, many enterprises are dealing with young workers that are formally educated, yet lack essential skills, such as teamwork, discipline, and organizational capabilities (World Bank, 2014, p. 19).

The formal education sector seems to be disconnected from the needs on the labor market; the students are not informed or stimulated to select vocations that may have potential for higher employment and earnings. These issues could be addressed by reforming the curricula, improved information about the labor market trends, career-counseling services, and increased involvement of the private sector in the skills improvement.

Macedonia has shown success in macroeconomic stability and improving the business environment, and the unemployment rate fell from 37.2% in 2004, to 32.2% in 2009, to 31.8% in 2012, to 28% in 2014, and to 24.6% in the last quarter of 2015. By the end of 2015, the total number of unemployed persons was 233,767 (State Statistical Office, 2016a, p. 2). Out of them, almost half were with 4 years of secondary education. The second largest group is the one with primary and lower secondary education – 23.1%. The ones with university degree came in third (41,424) - 16.6%. The country is still challenged with a high unemployment on one end, and then shortage of skills needed in certain sectors on the other end.

The unemployment rate is remarkably high among the youth, compared to the other countries in the region. Half (50%) of the active population in the age group 15-24 is

unemployed in the first quarter of 2016 (State Statistical Office of Macedonia, 2016b, p. 3). The inflow of more educated youth from the age group 20-29 on the job market results in increase of their share among unemployed workforce – one third of all unemployed (World Bank, 2014, p. 17). The high unemployment is also higher in the rural population, the people with lower degrees of education and members of ethnic minorities. However, according to Ms. Biljana Čklamovska, a legal expert, this high rate of unemployment might be overrated due to the high level of unregistered employment in the informal sector, which is estimated at 30 percent of the overall economy (Inedependent.mk, 2015). In addition, the unpaid work in family business is also present in the country, where, significant portion of the employment in the agriculture sector is consisting of unpaid family workers.

With reference to the skills mismatch, progress has been achieved in the better learning outcomes at the primary levels and the effect of compulsory enrollment in the secondary education. Yet, the enterprises in the automotive industry still have challenges, not only in hiring professionals for the management and technical positions, but also skilled workforce for the lower-skill positions. The producers in the apparel industry are facing with the same challenges. The brain drain is a major concern for the private sector, especially in the technical and engineering occupations. In addition, the R&D capacity is still weak, in light of the country's specialization in the low- and medium-tech industries (World Bank, 2013, p. 14).

There is a need for developing a plan for training and vocational education that would reply to the demand on the labor market and would reduce the incompatibility between the types of qualified labor offered on the labor market and the needs of the enterprises (UNCTAD, 2012a, p. 6). In that line, the government has reacted in right direction, in terms of increasing the budgetary support to the education sectors (4% of GDP in 2008). It notably increased the funding for construction and renovation of the school buildings and procurement of IT equipment. It also made the registering in the higher education mandatory. Nevertheless, the level of training and education of the workforce remains to be at the lower range in relation to the neighborhood.

The labor force survey performed by the State Statistical Office (2016c, p. 42) indicates that in 2015, 77.6% (547,797) out of the total employed persons (705,991) were employed in the private sector, while 22.4% (158,194) were employees in entities with other type of ownership (mixed, collective, state, or undefined). While all of the employed persons in the second group have a status of employees, in the private sector, 66.3% have status of employees; 5.6% have status as employers; 17.9% as self-employed; and 10.2% as unpaid family workers.

One of the key stakeholders on the labor market in Macedonia is The Employment Agency of the Republic of Macedonia. The objective of this agency is to foster the effective communication between the supply and demand sides of the labor market, and to assist in capacity building of the unemployed for better integration in the volatile labor market. The agency performs an analysis of the skill needs. It provides information on the state of the labor market, what are the expectations of the employers in terms of the new employments, and skills that job seekers should possess in order to become competitive on the labor market. In this survey, the employers are providing insight about their needs for new employees in the forthcoming 6-12 months, categorized by their occupations and skills, as well as the type of occupations that are in demand, but the employers could not find job seekers from those profiles.

The findings from this survey are used by the employment agency to create programs and other measures for equipping the job seekers with such skills that can address these needs, thus making them more competitive on the labor market. The findings from the survey should be also used as a solid base to create the action plans for employment at the local level as well as in developing the new curricula for occupations that could meet the demand on the labor market.

Its shortcoming is that it covers only the private sector enterprises that have seven or more employees in seventeen sectors.

In the coming 12-month period (the survey was conducted in October and November 2015), 49.5% of surveyed employers (1,417 out of 2,861 enterprises), expressed that they expect to realize 12,580 new employments; out of which 48.3% would be realized in medium enterprises; 28.4% in large enterprises; while 23.3% in small enterprises (Employment Agency of the Republic of Macedonia, 2016, p. 3).

According to the sector, 45% of the new employments would be realized in the manufacturing sector; 20.4% in the wholesale and retail trade; 9.6% in the construction, while 5.2% and 4.1% in the transportation sector and the sector of financial and insurance activities respectively.

According to the level of education, the most required will be the workers with completed secondary education (63.5%); followed by the workers with primary education (17.9%) and university education (10.8%).

The most wanted profiles among university graduates in the coming 12 months would be programmers, IT engineers, system administrators, software developers, graphic designers, engineering technologists, construction engineers, as well as economists and jurists.

In the category of workers with completed secondary education, where the most of the new jobs are expected to be realized, the most wanted profiles will be sewers, sellers, welders, locksmiths, carpenters, bakers, drivers, etc.

In the survey, some of the employers stated that the challenge they are facing is the lack of workers with appropriate occupation, insufficient job experience, lack of knowledge and skills to perform the work tasks.

Among the special skills that the potential candidates for employment should possess, especially those with a higher education degree are the knowledge of foreign languages, basic computer applications, as well as advanced IT skills that should be backed by appropriate certificates. In addition, special attention is paid to the soft skills – communication skills, ambition, accountability, trustworthiness, teamwork, flexibility, and other.

2.6 The Quality of Labor in Macedonia

One of the leading factors for the growth of certain economy is the stock of human capital. The higher the stock of human capital, the higher productivity, both on individual and organizational level; better prospects for employment and higher salaries; as well as better operations and practices at the organizational level.

If a well-educated workforce is one of the premises for a modern, innovate-driven, and export-oriented economy, as Macedonian aspires to become one, the link between the education and human capital must be sustained through a provision of high quality education (Mojsoska-Blazevski & Ristovska, 2012, p. 130).

While the share of the highly qualified workers in the Macedonian economy is growing, the structural factors still hinder the growth of labor productivity (The European Commission 2015, p. 31). The reforms in the education introduced by the government had shown positive results in greater participation in the education, reduction in dropping out from school, and increased enrollment in pre-schools. With reference to the tertiary education, the proportion of graduates at that level in the overall workforce increased by 4 percent points, from 14 to 18 percent in the period 2009-2013. However, given that most new jobs are offered mostly in the low-productivity sectors, one quarter of university graduate remains to be unemployed (ibid.).

There are no equal employment opportunities across the labor stock. Workers at age of 45 or more are long-term unemployed (more than 90% being unemployed for over a year and mostly over four years), with outdated and lower level of skills, and less adjustable to the volatile economic environment.

As for the youth, those that drop out early from education are restricted to work in the informal sector, while those with higher education are challenged with finding jobs appropriate to their education. In addition, there are other vulnerable groups that are faced with even lower chances for employment – certain ethnic groups (especially Roma), women, population from the rural areas and from the eastern part of the country, highlighting the need for policy measures that would be tailored to these specific challenges.

Half of the total net jobs (jobs created minus jobs destroyed) in the period 2007-2011 were for workers with tertiary education, although they constitute less than 25% of the total employed workforce in the country. On the other hand, in the same period, over 40% of the net jobs created were in the informal employments in the agriculture and retail trade. It indicates that due to the poor prospects on the labor market, workers did not have other choice but to accept jobs wherever they could find one.

In addition, the public sector in this period is absorbing more of workers with tertiary education, which makes the less-paid jobs in the private sector less attractive and hinders the shifting towards sectors that have higher productivity. Hence, the efforts for improvement of the labor market conditions should be focused towards increasing the labor demand in those sectors that are with higher productivity and higher salaries.

Among the remaining key challenges is the low participation, especially among women in the labor market, skills mismatches, as well as limited job opportunities in advanced industrial sectors (ibid.). For the past few years, the labor productivity is only 60% of the average productivity of the EU 27 (World Bank, 2014, p. 13). The structure of employment continues to be unfavorable, being predominantly in the low-productivity sectors, and agriculture.

The government is addressing these challenges through a set of active measures, including a range of employment subsidies as incentive for recruitment. However, the European Commission finds that the impact of these measures was weakened, because they did not address in adequate manner the fundamental structural causes of unemployment, and were not dependent on the performance evaluations.

With reference to the progress of the vocational education and training strategy for the period 2013-2020, its implementation is falling behind in several areas. While many measures were adopted, there is no comprehensive monitoring of their effectiveness.

In order to accomplish significant improvements in the labor productivity, the education system should tie the curricula more closely to the needs and requirements of the employers, especially the foreign investors in the higher value added sectors.

The focus of the education policy in the past few years is on increased education in quantity and quality, along with infrastructure improvements through school buildings renovation and IT equipment procurement. The government has addressed the increase of quantity in education through introduction of nine-year primary education, compulsory secondary education and increased subsidies to the public higher education. The efforts to improve the quality in education relate to revision of the curricula and training for teachers to promote interactive teaching and learning, learning of ICT skills and English at earlier stages of education, and implementation of the Bologna declaration.

2.7 The Effects of FDI in Macedonia

The effects of FDI on the development of the host country could be both, positive and negative. On the positive side, the FDI could contribute to increased GDP, higher employment, more diversified exports, transfer of advanced technology and skills, increased integrations of the domestic enterprises in the globalized supply chains, higher fiscal revenues and more developed transportation and ICT infrastructure. On the negative side, FDI could have a crowding out effect on domestic enterprises, they can monopolize particular industrial sector in the host country or have negative impact on the environment in the host country.

Given that the FDI inflows in Macedonia are moderate in comparison to the other countries in the region, one could expect that the impact on the Macedonian economy would be also limited. One major obstacle for a more thorough assessment on the systematic impact is the insufficient data. However, UNCTAD (2012a, p. 21) drew some conclusions about the impact of FDI that are significant in some industries (e.g., telecommunications and banking).

In 2012, UNCTAD evaluated the linkages between the domestic and foreign enterprises in Macedonia as weak, in general (UNCTAD, 2012a, p. 23). This is especially valid for the greenfield investments, where the enterprises are export oriented and import most of their production inputs. In enterprises acquired by the foreign investors, they have already established linkages with domestic suppliers, and they not only maintain these linkages after the acquisition, but there is a tendency to upgrade them. In the following period, things have improved, and, according to Mr. Viktor Mizo, the CEO of the Directorate for Technological Industrial Development Zones, in 2015, around 500 Macedonian enterprises cooperate with the foreign enterprises, mostly as their suppliers of raw materials, service providers for maintenance of their machines and equipment, transport and logistics, insurance, catering, and construction (Zdravkovska, 2015a, p. 27).

With reference to the technology transfer, it usually happens through the import of the advanced technology by the local affiliates from the mother enterprises. However, due to

the limited linkages, the transfer usually stays within the framework of the MNE and rarely spills over to the domestic suppliers. It encompasses the transfer of tangible assets, such as machines and technology, as well as transfer of intangible assets, such as knowledge and skills. The technology transfer could be further augmented through collaboration among universities and industries, or horizontal and vertical channels of collaboration within the enterprises, or setting up high-tech zones.

The enterprises that have opened their affiliates in the TIDZs are mostly efficiency-seeking FDI. The focus of the efficiency-seeking FDI is to take advantage of lower costs in foreign markets, especially lower labor costs. However, the spillover effects from their operations in TIDZs in the domestic economy still remain to be limited. For example, in case of Johnson Controls, with exception of some service suppliers (cleaning companies, electricity, telecommunications, transportation), there are few, if none, domestic suppliers in production inputs and very limited transfer of technology to local enterprises (UNCTAD 2012a, p. 24). The enterprise pays higher salaries than the average domestic one to the nationals employed in its affiliate, though.

Another foreign operation in the TIDZs, established by Johnson Matthey, is currently cooperating with more than 40 domestic enterprises, using them mostly for construction services and supply of raw materials, equipment, and other goods. Some of their suppliers already cooperate with their sister companies in USA, Great Britain, Russia, and other countries (Jordanova, 2014, p. 40). In terms of transferring skills, the affiliate does train its employees on basic quality standards, as well as health and safety, and environmental standards. The affiliate provides more job-specific training only to few divisions in its structure. With reference to the local suppliers, the affiliate does not provide training, but it gives them guidance on meeting the international standards of quality (ibid).

With reference to the resource-seeking FDI, in Macedonia they are established in the production of iron and zinc. These industries are capital-intensive and they use high and sophisticated technologies, which are difficult to imitate by local enterprises. Hence, the technological spillover is very limited. In addition, the employment in these industries is cyclical and is in correlation with the volume of production. In case of Makstil, the number of employees grew in parallel with the growth of production. From 806 in 2005, the number of employees peaked in 2008 to 1091 as the production grew, while in 2014 the number of employees is down to 791, which reflects the declining production in that and prior years (Makstil website).

In general, the spillovers, i.e. the level of backward linkages with the foreign investors, are relatively low for the domestic economy. The main reason for this is the low capacity of the local producers to meet the technical and safety standards for export in the EU. However, there has been some progress in the past few years. According to one survey in 2013, the total value of procured goods and services that foreign enterprises bought by the domestic suppliers amounted to Euro 50 million, which is almost quadruple from Euro 11 million in 2011 (Jordanova, 2014, p. 41).

The experience of local enterprises is such that foreign operations make initially very small symbolic orders, as trial orders, before expanding the cooperation. The local enterprises are using the cooperation with the foreign enterprises as a good reference for entering in new markets, especially the European ones (ibid, p. 44). The local small and medium enterprises mainly export to the neighboring markets, and the possibilities to integrate in the European supply chains are still limited. The prospects for establishing backward linkages are hampered by the credit and liquidity constraints that domestic enterprises are facing with. The high collateral requirements and the delays in collecting payments are among the major constraints for the local enterprises for doing business.

In addition, the current legal framework of the labor market does not stimulate the spillover effects in terms of drawing and disseminating new or missing skills. The lack of differentiation between foreign employees that would work in Macedonia at the managerial posts or that possess some special technical and professional skills, and foreign workers that are low skilled, may negatively affect the attraction of professionals and skills required for certain FDI projects and consequently the attractiveness of Macedonia as FDI destination in general.

2.8 FDI Impact on Employment

One of the most persistently economic and social challenges in Macedonia remains to be the high unemployment rate. Macedonia struggled with high unemployment even in former Yugoslavia, since 1970s (Saveska, 1999, p. 2). Ever since 1976, the unemployment rate (the ratio between the number of unemployed people and the total labor force) in Macedonia was above 20%, being one of the highest rates among the Yugoslav republics. The situation just got worse in the beginning of the transition period.

The unemployment rate in 1993 jumped to 27.7%, and further rose to 36% in 1997 (Figure 8). This was the period when the privatization process of the socially owned enterprises was at the peak. The privatization process itself stirred a lot of controversy, because of the implemented method – selling the enterprises to their employees instead of strategic investors who would bring fresh capital and new technology, skills and methods in management. It also resulted with surge of the redundant workforce, which was reflected in new dismissals of the employees and increase of the unemployment. In the period from 1997 through 2012, the unemployment rate was persistently in the 30-range percentage, with 30.5% in 2001 being the lowest. Only in 2013, the unemployment rate falls to 29% and further declines to 26.1% in 2015; still higher than the already high 23.5% rate in 1990

(Saveska, 1999, p. 4). In that line, Macedonia greatly needs job creation, and consequently, one of the questions related to the FDI is the extent to which they could generate jobs.



Figure 8: Unemployment Rate in Macedonia 1993-2015 (%)

Source: National Bank of the R. Macedonia database, Basic economic indicators, 1993 - 2015.

The effects that FDI have on the employment in the host country can be direct; when FDI generate new jobs. This is typical for the greenfield investments. The effects could also be indirect, which incur when jobs are being created in the domestic enterprises because of the forward and backward linkages with FDI.

Most of the FDI in Macedonia are in form of cross-border M&As, almost double than greenfield investments (Figure 9). The M&As are mostly concentrated in labor-intensive activities (such as telecommunications services), and where the share of employees per equity capital is higher in comparison to the greenfield investments. Consequently, in 2009, the M&A companies had 51,236 employees, whereas the greenfield investments provided jobs for 17,850 employees (UNCTAD 2012a, p. 21), which is 10% and 3.5% respectively, of the total employed in the industry and services sectors combined (National Bank of Macedonia statistics).



Figure 9: Structure of Direct Investments* 1997-2014 (in EUR)

*Note.** The statistics of the National Bank of the Republic of Macedonia is based on the Methodology BPM6 and provide data on direct investment stocks, which is the direct investment position at the end of the year. The data contain equity (including reinvestment of earnings) and debt instruments. The changes in stocks between two years are results of transactions, price changes, exchange rate changes, and other changes in volume (from NBRM website).

Source: National Bank of the R. Macedonia Database, External statistics, 1997 - 2014.

3 ANALYSIS OF THE FDI IMPACT ON THE EMPLOYMENT

Taking into account the importance of the exports for the economic growth and jobs creation, and given that the biggest portion of the Macedonian exports is being generated in the mining and manufacturing industries, where growing part of the FDI in the past years is being allocated, the focus of the analysis is to evaluate the impact of the FDI on the employment in these sectors.

The basis of the analysis is the model that Krstevska and Petrovska (2012, p. 71) have applied to measure the economic impacts of the FDI in Macedonia. They have evaluated the FDI impact on the employment in the mining and manufacturing sectors in the period 2001-2007, by applying the method of panel data analysis with random effects.

In comparison, the analysis of the effect that FDI have on the employment in the mining and manufacturing industry, subject of this paper, covers the period 2001-2013, and it is based on the following model of panel data analysis with random effects:

$$ln(EMP) = a + b*ln(FDI) + e$$
(1)

Upon testing the model in several trials with different time lags, the model that incorporates the 3-year lag dimension had shown statistically significant results, as presented in Table 1:

Random-effects GLS regression Group variable: i					Number of obs = Number of groups =			47 14
R-sq:	within = between = overall =	0.2680 0.5949 0.4163			Obs p	ber group:	min = avg = max =	2 3.4 4
corr (u_i, X) = 0			(assumed)			Wald Prot	chi2(1) = o . Chi2 =	13.48 0.0002
Inemp		Coef.	Std. Err.	Z	P> z	[9	95% Conf.	Interval]
Infdi L3_		0.1270369	0.346029 <mark>_</mark>	3.67	0.000	C	0.0592165	0.1948572
_cons		7.997081	0.332469	24.05	0.000	7	7.345454	8.648707

Table 1: Estimates of the Parameters in the Equation (1)

The interpretation of the key results is as follows:

- Prob > chi2 = 0.0002. If this value is < 0.05, then the model is OK. This is a test that indicates whether all the coefficients in the model are different from zero.
- Coefficient for lnfdiL3 = 0.1270369. This coefficient indicates how much the employment changes when the FDI increase by one unit. This result would be interpreted as follows: one percent growth of the FDI stock yields 0.13 percent increase in the employment after three years.
- z = 3.67. This is actually the t-value, which tests the hypothesis that each coefficient is different from 0. To reject this, the t-value has to be higher than 1.96 (for 95% confidence). In this case, t-value is higher than 1.96, which means that the variable does have a significant influence on the dependent variable employment after three years, in this case.
- P>|z| = 0.000. This is actually two-tail p-values, which test the hypothesis that each coefficient is different from 0. To reject this, the p-value has to be lower than 0.05 (95%). If this is the case, then it can be said that the variable has a significant influence on the dependent. In our case, the p-value is lower than 0.05, *ergo* the variable FDI has significant influence over the employment after three years.
The model of Krstevska and Petrovska has shown a negative and statistically significant effect of FDI on the employment in the mining and manufacturing sectors in the period 2002-2007. Their analysis indicated that when the FDI stock grows by one percent, that negatively influences the employment in the subject sectors by fall of 0.16 percent (Krstevska & Petrovska, 2012, p. 72). The authors elaborated that the reasons why FDI inflows are not followed by increase in employment should be looked into the type of foreign investments in the selected sectors, the type of industries where FDI are located, and the distribution of labor across the sectors. They highlighted that the potential for job creation is higher in case of greenfield investments in comparison to the M&As of the existing local enterprise. The greenfield investments in Macedonia are at a lower level at the time of their research, being 63% of the M&As' level in 2007. The FDI in Macedonia were mostly allocated in the capital-intensive sectors, where the opportunities for new jobs are more limited in relation to the labor-intensive sectors, which were less attractive to foreign investors. Furthermore, the biggest part of the workforce in Macedonia was employed in the textile industry, a labor-intensive industry in nature, but FDI in this industry were small. Last but not least, the foreign investors did not establish close links to the local suppliers, given that they were importing the main part of the inputs for their operations (ibid).

In comparison, the results of the panel model with random effects with three-year lag applied for the period 2001-2013 (Table 1), suggest that FDI have positive effect on the employment in the targeted sectors – growth of one per cent in FDI stock results with increase in employment of 0.13 percent after a period of three years.

One of the reasons for the transformation of results from negative in the former model to positive in the latter is the fact that after 2007, when the government initiated the new strategy for attracting FDI, the number of FDI in TIDZs, which are all greenfield investments, started to grow. The volume of M&As, most of them in the labor-intensive industries and characterized with higher employees-to-equity-capital ratio, is still double than the greenfield investments (Figure 9). Nevertheless, Macedonia is ranked third in greenfield projects per capita and seventh in total greenfield projects in Eastern Europe in 2016 (Site Selection magazine, 2016). This is supported by the fact that the exports from the TIDZs were showing double digits growth in the past few years, being almost 40% of total exports in 2014 (IMF, 2015, p. 6.), where most of the producers of automotive components, which are also the biggest exporters of Macedonia, are located. Johnson Matthey is the biggest exporter from Macedonia (20% of the total export). According to the latest analysis of the National Bank of Macedonia, the net exports of the fifteen enterprises from the TIDZs was 2.6% from the GDP in 2014 and 2015, and the trend continues in the first five months of 2016. In the same period the exports from the TIDZs provides almost 50% of the total exports of the country (NBRM, 2016, p. 63). On the other side, as Mizo indicates, the enterprises from TIDZs became also the biggest importers of inputs for their production processes, so the net export effect from the FDI in Macedonia can be estimated at Euro 133 million in 2014, i.e. 11.4% of the realized export (Zdravkovska, 2015a, p. 27). As for jobs creation, the number of jobs opened in the TIDZs exceeded 3,500. When the number of new jobs opened by foreign investors out of TIDZs is added, the total number of new jobs created by the foreign investors amounts to 13,000 (Zdravkovska, 2015a, p. 25), which is 6 percent of the total employed in the industry in 2015 (NBRM statistics). While the core of the competitive advantages of the country continues to be in the production of intermediate and consumer goods (textile, tobacco, food and beverages industries), Macedonia also becomes increasingly competitive in the more capital-intensive sectors, such as production of chemical products (IMF, 2015, p. 6).

The positive trend in job creation by foreign investors continues in 2015. The IBM Institute for Business issued a report in August this year on global location trends in 2016, where Macedonia is ranked at the first place worldwide in jobs per capita created by FDI. Macedonia in 2015 attracted more than 6,000 jobs in FDI projects, and when compared to the number of inhabitants, the country has attracted 2,900 new jobs per 1 million inhabitants, which brings her to the top of the list (Dnevnik, August 2016). Key features of Macedonia that contributed to these results are the operational costs of the companies, the labor costs, and the corporate tax, that are still very competitive in the European context. In addition, it is very important that the workforce is of good quality, the companies that invested in Macedonia in the past years are successful, they have good results, and more of them already reinvested in the country, which confirms that they are satisfied with the quality, the technical skills, and the productivity of the workforce (ibid).

Part of the progression from negative towards positive influence by the FDI on the employment can also be related to the indirect effects in form of the backward linkages with the domestic enterprises. There has been progress in this area in comparison to the period from 2002 to 2007 covered in the study of Krstevska and Petrovska (2012). The survey of the business magazine "Kapital" indicated that the value of goods and services sold by the domestic enterprises to the foreign ones totaled Euro 50 million in 2013, almost quadruple for the period of two years (Jordanova, 2014, p. 41). For example, Johnson Matthey already established cooperation with 40 local suppliers of raw materials, equipment, and other goods (ibid). For some of their local partners, this cooperation opened the door for supplying the Johnson Matthey's sister companies in other countries, which indirectly also has a positive effect on employment in general.

Although the results from the model speak in favor of the effects that FDI in mining and manufacturing sectors have on employment, the conclusions and following implications on the policy cannot be straightforward. One reason for that is the poor quality and limited

availability of data¹. This handicaps the possibility for more holistic analysis of the relations between the employment, the level of salaries, as well as the level of productivity in FDI in comparison to the aggregate levels at the industry and the national level. In addition, for further evaluation of the impact of FDI on the employment, it would have been useful to analyze the employment proportion between the types of FDI in these sectors (greenfield investments vs. M&As); taking into consideration the fact that the former generate more new jobs, while the latter might even cut jobs. The public availability of such data remains a challenge. Furthermore, the analysis is focused on the impact of only the FDI on the employment. However, besides the FDI in the new capacities opened in the TIDZs, there are also other factors that influence positive changes in the employment. Some of these factors are: (1) the fiscal stimulus in form of agricultural subsidies and (2) publicly funded construction works (NBRM, 2014, p. 26), which result with the most new jobs created in the construction and agriculture (ibid, p. 27). The manufacturing industry also contributes to the new jobs creation, which can be allied to the new operations in the TIDZs (ibid, p. 27). The increase in export supports these trends, where the biggest contributions come from the facilities located in the TIDZs. In the first seven months of 2016, their exports exceeded Euro 1 billion, which makes 40% of the total exports (Kapital, 2016). In addition, the active policies by the government for supporting new jobs and entrepreneurship resulted with historical high number of self-employed professionals - about 100,000 persons (NBRM, 2014, p. 27). Simplified procedures for opening and running business makes a contribution, too. In addition, the public sector is still the main employer (EC report, 2015, p. 48). To capture the impact of these factors, additional variables should be introduced in the analysis, for which, either there is no data or it is not easily accessible.

CONCLUSIONS, POLICY IMPLICATIONS AND SUMMARY

• Conclusions

One of the ways for poorer developing countries to enhance their prospects for economic growth is by attracting FDI. They are considered not only as a source of capital, but also as a channel for transferring know-how in technology and management, that will ultimately have a spillover effect on the rest of the host-country economy. In addition, FDI are considered as one of the factors that would help alleviate the unemployment problem by creating new jobs, not only in the foreign facilities, but indirectly in the domestic enterprises engaged in their supply chains as well. Another benefit from FDI that

¹The only publicly available data on the number of employees and the average gross wage per employee in the business entities with foreign direct investment, by activities, covers the period 2003-2007 (<u>http://www.stat.gov.mk/Publikacii/3.4.9.01.pdf</u>). There is no new data for these indicators either at the State Statistical Office of Macedonia or at the National Bank of the Republic of Macedonia.

developing countries are aiming at is their contribution to country's productivity growth. Furthermore, the FDI effects on employment are also related to the types of foreign investments. While greenfield FDI positively impact employment through creating jobs in the new facilities, M&As may have negative effect through cutting redundant jobs in the transformed enterprise as an outcome of the efforts to improve their productivity and competitiveness. However, developing countries should not expect that the FDI would solve all of their problems they are facing in their development efforts. FDI would not generate growth or overcome poverty in isolation from other factors in the economy, education, or health sectors.

As a developing and transition economy, Macedonia is facing the same challenges as the other economies in this category, high unemployment rate being one of the biggest. In addition, FDI are considered as one of the resources to create new jobs and help reduce this economic and social problem in the country. Since 2001, in their efforts to increase the levels of FDI and investments in general, several Macedonian governments had implemented many measures to improve the business environment, including the legal and economic environment for the investors. Macedonia can offer the following factors attractive for FDI: political and macroeconomic stability, open market economy, fairly skilled and motivated workforce, labor costs and corporate tax that are still very competitive in the European context.

Given the chronic high unemployment in Macedonia, and all the promotion and incentives that the country is offering to attract FDI, the focus of this paper is on analyzing the impact that FDI have on the employment in the mining and manufacturing sectors, where most of the recent FDI took place. Taking into consideration the available data, a model of panel data analysis with random effects was applied in the research, following the example of Krstevska and Petrovska. Several trials with different time lags indicated that only the model with the three-year lag dimension gives results that are statistically significant. The coefficient of FDI (0.13) implies that there is an indication of positive dynamics between FDI and the employment in the mining and manufacturing industries – one percent growth of FDI in these sectors causes an increase of 0.13% in employment in these sectors with a three-year lag.

The result differs from the one that Krstevska and Petrovska got with their model – statistically significant, but negative FDI influence over employment. Among the key reasons for the difference in the results are: (1) the period covered with the model applied in this paper (2001-2013) is much longer than the one covered in the model of Krstevska and Petrovska (2002-2007); (2) the number of greenfield investments increased after 2007 through the new factories opened in the TIDZs, which resulted with more than 3,500 new jobs in TIDZs, and when combined with all the other jobs created by foreign investors, come to the total of 13,000 (6% of all employed in the industry); and (3) the increased

level of cooperation with local suppliers, which resulted with quadrupled sales of goods and services by the local suppliers in the period 2011-2013. Despite the handicap of limited availability of good data that could have been incorporated in more substantial analysis including the influence of other variables on the employment besides FDI; the result of this research indicates that the impact of FDI at this moment, although positive, is not yet crucial in reducing the unemployment in Macedonia.

• Policy Implications

It is important for the countries with small domestic market, such as Macedonia, to be open to the global market and well connected through the international trade, because in that case they can provide to the foreign investors opportunities to reap the benefits from the economy of scale, similar to the countries with big domestic markets. Hence, trade openness plays an important role in attracting FDI. The tax breaks and other incentives that the government offered have brought results in attracting FDI, yet with a price. On the positive side, the FDI were drawn in industry sectors whose output can be traded internationally. That led to re-structuring of the exports, with growing participation of the technology-intensive products that is also leading towards growing contribution of the exports to the economic growth. These processes have also positive impact on the employment. On the negative side, the policy of high fiscal incentives for the foreign investors has reached its limits, especially in comparison with other countries that apply similar policies to attract FDI. There is a risk of insufficient generation of public revenues needed to finance the public administration that can function effectively and provide the public services at adequate level (UNCTAD, 2012a, p. 44). Furthermore, many surveys of the investors and studies have indicated that for their investment decision, more important is the presence of a **business-friendly climate** with **low incidence of corruption** and **clear** and transparent regulations that are being effectively enforced by the rule of law; than offering of any type of fiscal incentives. It is logical to assume that the foreign investors would have a preference to invest in countries that have lower input costs, as well as operation and hidden costs, because that would provide opportunities for higher profits (Mottaleb & Kalirajan, 2010, p. 7).

With reference to the **infrastructure**, the condition of the roads is relatively poor and requires upgrade and rehabilitation in order to enhance the prospects for economic growth (World Bank, 2016a, p. 10). As a landlocked country, it is of key importance for Macedonia to improve its infrastructure into efficient and high quality one, and with good international connections, for which, the country could rely on FDI in this sector, through private-public partnerships, for example.

Besides the improved business environment, Macedonia implemented comprehensive economic reforms in the **labor market**. The unemployment dropped from 37% in 2004 to

26% in 2015. In spite of these accomplishments, the country continues to face significant challenges with the employment and jobs creation, manifested on both, the demand and supply side of the labor market. While, on the demand side, there is a need for more productive and better-paid jobs in the private sector, on the supply side, there is a need for more employment opportunities for the entire workforce, especially some vulnerable groups like youth and older women.

The **salaries** in foreign enterprises are not high, but the workers are getting new skills, knowledge through training, and re-qualifications. Taking into consideration that the state is partially covering the training costs, and that the foreign employers are exempt from paying personal income tax, social and pension contributions for the employees, one can conclude that the effects from FDI are mainly in salaries paid to the employees, which should increase the domestic consumption.

The government should tailor its policies toward stimulating creation of jobs with higher productivity, equipping workers with appropriate skills for such jobs, and fostering the increase of productivity in the low productivity sectors. This is especially important, having in mind that the labor productivity in Macedonia is still low, with 60% of the average productivity of the EU (World Bank, 2014, p. 13). However, this is a long-term transition process, and not all workers will be able to upgrade their skills or move to sectors where new jobs are being created. Hence, in short and medium term, the expectations should be that dominant part of the employed workforce would still be in the low productivity sectors.

The government should continue to focus its efforts in improving the quality of education, youth attainment at schools, and supporting life-long learning. Macedonia can follow the example of Finland and Ireland, which achieved high grow rates in the past decade by relying on the potential of their human capital and knowledge (Yusuf & Nabeshima, 2012, p. 3). The educated youth should be encouraged to look for a job in the private sector or get self-employed, instead of looking for opportunity to enter the public administration. Furthermore, it should be assisted to get access to jobs that not only provide useful work experience, but also provide sufficient salary with potential for growth. As for the older generations that are mostly trapped with lower and less adjustable skills, they also need help in improving their prospects on the labor market for new jobs. The efforts should be directed towards helping them upgrade their skills, so they become self-employed or active job seekers. The enterprises should be assisted for investing in continued building of their worker's skills, such as on-the-job training. In addition, the dynamic development in technology and innovation requires new types of skills as well as capability to change the current skills in response to these changes. In that line, the education and training structures should be reactive to the new skills requirements, and they should cultivate the worker's capability to adapt over the working life.

Another important aspect is nurturing of the **entrepreneurship** in the country. Entrepreneurs and managers play a key role in translating ideas into successful businesses. When the entrepreneurship is weak, the new technologies and innovative ideas are not being tested on the market, which hampers the growth. Macedonia needs to turn upside down the mentality of fear of failure, and follow the dynamic economies that are highly entrepreneurial, with culture that rewards the initiative and risk-taking, and is tolerant of failure (Yusuf & Nabeshima, 2012, p. 18). The entrepreneurship should be accompanied by strong managerial skills that can lead the enterprises over the start-up phase into their full potential.

Diaspora could also play a very important role in supporting the economic growth of the country; not only by sending remittances to their relatives, but also by returning of the people who got skills abroad and who could also bring their business partners from abroad. According to the International Organization for Migration (2007, p. 15), the Macedonian diaspora is estimated at approximately 370,000 living abroad, most of them living in Australia, Germany, Italy, Turkey, Switzerland and the United States. The government built close ties with the organization Macedonia 2025, an international organization that was founded by successful Macedonians from the diaspora back in 2007. The objective of this organization of Macedonian expatriates is to promote Macedonia as FDI destination, introduce new competitive approaches, and transfer the management and entrepreneurial skills for more successful domestic enterprises (Macedonia 2025, 2015). This fruitful collaboration between the Macedonian government and Macedonia 2025 organization resulted with organizing the First Global Investment Summit for Macedonia, held in Ohrid in 2012. At this event, Mike Zafirovski, co-founder of the organization, praised the incentives for the foreign investors, the low taxes, and the cheap workforce, as reasons for increased interest among the foreign investors (Kapital, 2012, p. 6). Jatin Thakrar, the general manager of Johnson Matthey plant, stated that they have excellent conditions for their investment in Macedonia - low costs and excellent workforce. Therefore, the company decided to build a second catalyst manufacturing plant in the TIDZ Skopje 1 -Bunardzik (opened in 2013). However, he also stated the same issues that require improvements – the procedures of the public administration, the employment of foreigners, and more precise law regulations that sometimes can be differently interpreted (Kapital, 2012, p. 20).

Promoting the country as favorable FDI destination and offering incentives to the potential foreign investors is definitely worth appraising, however, the government should not neglect the domestic sector as well. This is more appealing when the volumes of investment made by both, domestic and foreign investors are compared. In 2014, the investments of the domestic enterprises amounted to EUR 965.2 million, which is double the amount of FDI for the same period (Janev, 2016, p. 21). In addition, one should keep in mind that domestic businessmen are not getting any subsidies or tax exemptions, and they

pay all the taxes and contributions to the budget and state funds. The analysis indicates that the government had spent EUR 56.6 million in the period 2007-2014 as state aid to the foreign investors, which means that the cost to the state for each work place opened by the foreign investors was EUR 21,000, and four out of seven foreign enterprises would work with loss if there were no subsidies by the state. FDI participate in the export with 27 percent, while the value added to the GDP of the seven enterprises in the TIDZs that received state aid is EUR 56 million, which is less than 1% (Zdravkovska, 2016, p. 18). All these facts indicate that government should offer equal treatment to the domestic enterprises as well. Indeed, same factors as for FDI play important role for growth of the local enterprises: business-enabling environment, efficient rule of law and public administration, solid infrastructure, and workforce whose skills match the needs of the economy. In addition, the domestic enterprises are asking for cheaper loans, reinstitution of the credit fund, more expedient procedures for issuing construction permits, and return of the technical high schools that would provide the workforce with required skills (Jordanova, 2014, p. 44). These arguments do not contradict the fact that Macedonia needs FDI as additional resource of capital for production growth. On the other hand, there is also a valid question whether Macedonia should base its sustainable and long-term economic growth solely on FDI, and whether they can be a substitute for the insufficient investment in the domestic economy.

• Summary

There are still significant challenges that country needs to deal with. Ozawa, 2005 (in Dunning & Lundan, 2008, p. 338) argues that countries that benefit the most from FDI are those that are able to adapt their institutions to the needs of the global market and that can use the FDI to restructure their economy. Being a small market and with relatively scarce natural resources, Macedonia should target its efforts in attracting FDI by enterprises that are export-oriented and that will help the country to better integrate in the regional and global supply chains. In long run, the country should not focus only on the jobs creation by FDI, but also the type of jobs that will be created. The real challenge will be in attracting investment projects that are of higher value and that will offer jobs that are knowledge-intensive and with bigger salaries, such as in the ICT and financial services sectors. Kristijan Danailovski, the executive director of FX3X Macedonia commented that Macedonia has already been identified as a land of opportunities in the IT industry (Kapital, 2012, p. 31). As a small economy, Macedonia has a potential for growth that relies on services sector, supported by investing in computer literacy, ICT and related skills. The government should keep an eye on the technological developments and innovations (automation, robotics, 3-D printing) that influence the production and value chain processes in the targeted industries. As with the breakthrough in the telecommunications and the internet twenty years ago, these developments in the technology will also impact the investment decisions, in all sectors where the new

technological solutions will lower the production costs and improve the quality of the products and services, and eventually will reduce the importance of low labor costs, one of the key drawing FDI determinants in Macedonia. This would require redefinition of the country as a source of cheap labor towards a **country that offers highly skilled and productive labor** that is ready to be integrated in the upgraded industries that are driven by automated technologies. In order to accomplish that, the government needs to cooperate closely with the education and private sector in crafting a workforce developing strategy that will enable Macedonia to grow into a competitive link that **successfully integrates into the new production processes of the globalized economy.**

Lastly, one cannot reiterate enough the importance of securing **good governance**, in **general** - business-enabling environment with stable legal framework and effective and transparent rule of law. In terms of Macedonia, there is still a room for improvement in the judiciary, in simplification of certain procedures and solving administrative bottlenecks (hiring foreign citizens, issuing construction permits), and in strengthening the capacity of the public administration. This is important not only for FDI, but also for the domestic sector as well. Having in mind the contribution of the domestic enterprises in the GDP creation, Macedonia could make a quantum leap by more targeted support of the domestic enterprises should not be neglected, since they invest more than foreign operations in the country.

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APPENDIX

LIST OF APPENDICES

Appendix A: List of Abbreviations	1
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Appendix A: List of Abbreviations

ASEAN	Association of South East Asian Nations
BIT	Bilateral investment treaty
CEFTA	Central European Free Trade Agreement
CII	Creative investment institution
COMECON	Council for Mutual Economic Assistance
EFTA	European Free Trade Agreement
EPZ	Export-processing zone
EU	European Union
EUR	Euro
FDI	Foreign direct investment
FIC	Foreign Investors Council
FTZ	Free trade zone
GATS	General Agreement on Trade in Services
GDP	Gross domestic product
ICT	Information and communications technology
IMF	International Monetary Fund
IT	Information technology
M&A	Merger and acquisition
MKD	Macedonian Denar
MNE	Multinational enterprise
NAFTA	North American Free Trade Agreement
NBRM	National Bank of the Republic of Macedonia
OECD	Organization for Economic Co-operation and Development
R&D	Research and development
RIF	Regional integration framework
SPE	Special purpose entity
TIDZ	Technological Investment Development Zone
TNC	Transnational corporation
TRIMs	Trade-Related Investment Measures
TRIPS	Trade-Related Intellectual Property Rights
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
USA	United States of America
VAT	Value added tax
WTO	World Trade Organization