

Legal and Financial Regulations to Create New Investment Opportunities in Macedonia

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Abstract: As a small, open economy, Macedonia continues to take active steps to attract foreign direct investment (FDI). The country has enacted legislation that not only ensures an equal footing for foreign investor's vis-à-vis their domestic counterparts, but also provides numerous incentives to attract such investment. The legal system in Macedonia is undergoing substantial reforms. However, it is still slow, inefficient, lacking the adequate resources, and sometimes subject to political pressures and corruption. Enforcement of the law and upholding of contracts is inconsistent and not always impartial. This paper examines the legal changes in Macedonia and its effect on FDI from the historical perspectives and forecast on strategic management changes simplifying the administrative decisions on investment. New legal and administrative regulations on investment incentives for FDI and business regulations will provide a new momentum for the economic development of this EU candidate state.

Keywords: FDI, financial and legal regulations, institutional capacity

Introduction

Strategic priorities and goals of the Government of the Republic of Macedonia are follows; increasing competitiveness on a constant basis, higher employment rate, fostering foreign and domestic investments, strengthening the Public-Private Partnership and empowering the administrative capacities. The maintenance of macroeconomic balance and stability of the national economy, based on sustainable economic growth, mainly by encouraging the domestic investments and attracting foreign investments, as well as the increased level of the public investments. (2009 - 2011 Public Investment Program)

The Government of the Republic of Macedonia emphasizes the priority of creating conditions and prerequisites for successful implementation of Stabilization and Association Agreement with the European Union, the Agreement with the World Trade Organization (WTO) and the Central European Free Trade Agreement (CEFTA). These agreements, together with the concluded contracts, i.e. free trade agreements with other countries in the region and in wider frames, are solid grounds for increasing the economic cooperation abroad, restructuring the economy and thus the total development.

Understanding the role and function of law in the international business environment is a critical skill for the international manager. Only by understanding the range of issues and the elements and characteristics of the legal system, and by developing a clear knowledge of who will be the key decision-maker in the legal environment, the international manager can avoid the traps and being of unknowledgeable in a globalized economy. (Hunter and Shapiro, 2008)

Official reports confirm that Macedonia has made important progress in the economic stability and its macro economic system. The inflation and budgetary deficit have reached comparative level with EU. However, the base for product growth has not been ensured. The budget is dependant from foreign investments; the private sector is weak and the foreign investments level is low.(Sela, 2008)

During the last crisis, IMF and World Bank arrangements partially substituted the lack of broad based consensus for the transition reforms. Due to falling output and increasing unemployment and poverty, the authorities

were not able to create compensating mechanisms for the transition period losers. A major weakness exists because of the weak institutional framework and especially the lack of the firm rule of law. Despite considerable support of the reforms by the international financial institutions, the inflows of private capital and foreign direct investment were low, while export growth was stagnant. Due to the delayed transition and high social costs there is widespread public feeling of “reform fatigue”. (Petkovski, Bishev, 2004)

According to evaluation of the legal system in Macedonia done by IMF in 2003, the country does not have an adequate legal system to effectively enforce contracts. Consequently, big part of the economic decline in Macedonia is due to improper and corrupt privatization and limiting liberalization reforms, which increase the amount of rent-seeking activities and create a vicious cycle of politically powerful elite.(IMF, 2003)

Continuous institution building, reforms in the financial and real sectors and the continuation of sound macroeconomic policies are the only ways for bringing more dynamism into the Macedonian economy. In this regard, the entrance of the reputable foreign banks has increased the industry’s efficiency and represented a solid background for promotion of other sectors’ restructuring and for acceleration of the economic growth. The process of EU accession could give additional impetus for accelerating and finalizing the transformation into the modern market economy.

The most important way for unemployment reduction is economic growth. In principal, lowering transactional costs and removing barriers to business are crucial for creation of favorable investment climate and attracting FDI and enhancing exports and investments, as the sources of growth of the gross domestic product and the employment,

Strengthening the efficiency of public institutions and regulatory agencies.

Market economy depends on functional and efficient institutions. In Macedonia market regulating institutions are new, understaffed, with moderate experience. The lack of tradition in the regulation by the state and the inexperience of the Macedonian institutions in this area is a potential serious handicap. The nature of the privatization process and the inefficient banking system limited the interest of foreign investors in Macedonian companies and the capital market. It is necessary to accelerate the reforms in the area of the market legitimizing institutions. In order to create new investment opportunities the following reforms are required;(Macedonia National Action Plan for employment 2004-2005, 2003)

- Improvement of entrepreneurship at all levels, legal protection of private investment, improvement of business culture, banking sector development, finalize privatization,
- Improvement of corporate governance, as a precondition for the development of the private sector and growth of the entire economy,
- The comprehensive policy of Small and Medium Size Enterprises (SMEs) growth, as an instrument for employment creation.
- Reforms at all levels of the educational system, as the investment in human capital is a precondition for poverty reduction,
- Reform of public administration, to increase transparency and reduce corruption,
- Reforms in the local self-government, to support the local economic development, through capacity enhancement of municipalities and by creating local development institutions.

SMEs in Macedonia

Almost all of the companies in Macedonia are registered as small enterprises, employing about 55% of the employees in the private sector. According to the main activity registered, the majority of businesses are in the wholesale and retail trade sector (47%), manufacturing sector (13.1%), and the transportation, storage, and communications sectors (approximately 10%). The largest employer is the manufacturing sector, with 35.6% of the total number of employees in the private sector.

The Macedonian Government puts a high priority on the development of the SME sector, focusing on measures and activities to support the development and competitiveness of SMEs, and to improve the business environment in general.

The strategic framework for support of SME development is defined by the following documents:

- The Small Business Development Strategy,

- Program on Measures and Activities for the Promotion of Entrepreneurship and Creation of Competitiveness of the SMEs in the Republic of Macedonia,
- The European Charter for Small Enterprises,
- The Law on Realization of Handicraft Activities,
- The Law on the Agency for Promotion of Entrepreneurship of the Republic of Macedonia.

In order to achieve a higher degree of coordination among the relevant factors, the National Council for Competitiveness and Entrepreneurship was established as an advisory body to the Government, linking the private and public sector to improve the climate for entrepreneurship development.

The Agency for Promotion of Entrepreneurship of the Republic of Macedonia is the major player on the national level for the implementation and coordination of national and international support to the small businesses. The Agency works in cooperation with various foundations, development centers, centers for technology transfer, Euro Info centers, as well as private consultants.

Legal aspects for Investment in Macedonia

An increase of FDI inflows is crucial for the catching-up process and international competitiveness of Macedonia and consequently for the acceleration of the EU integration process. The positive effects on growth and welfare are being obtained from trade through the liberalization of markets for goods and capital. Positive effects of foreign direct investment (FDI) for the host country are transfer of technological know-how, implementation of advanced management structures and modernization of the manufacturing sector to raise the competitiveness of the economy, facilitating access to western markets and stimulating growth. (Zakharov, Kušić, 2003)

The Government of the Republic of Macedonia has introduced the flat rate tax system in 2006. This policy provided economic stimulus for the private sector in Macedonia and has been welcomed by IMF and independent experts. (Stojkov, Nikolov, Smilevski, 2008). The main driving forces behind the tax reform were the desperate need to FDI inflows to solve the problem of high unemployment. In order to provide impetus for vigorous restructuring, the Government of Macedonia decided to design competitive tax system. Positive experiences from other countries (Estonia, Lithuania, Latvia, Russia, and Slovak Republic) gave strong justifications for the tax reforms in Macedonia.

The greatest benefit from the flat rate tax system is the introduction of tax simplicity, replacing the complexity of tax calculations that taxpayers have to deal with. It seemed unavoidable to envisage lower tax rate as part of the new tax reform proposals, given the fierce tax competition in the region. Cutting the tax rates and broadening the tax base hinders the incentives for tax evasion. In return, the fiscal discipline of taxpayers increases as seen by the improved collection of taxes. As a consequence, Macedonian corporate income tax revenue had been realised 60% higher than the planned one in the first half of 2008. Despite some calls for radical reforms, the rate of value added tax (VAT) was not aligned with direct tax rate, because of the substantial risk that tax revenues will fall dramatically.

Despite the risk of revenue loss, the collection of tax revenues has been surprisingly good. This leads to a conclusion that Government needs a more methodical data analyses on various taxes that would help in making forecasts on tax revenues. The survey results indicate that despite the initial success of the tax reform there is still more to be done in the tax legislation and the preparation of legislative changes. The main conclusions and policy recommendations are summarized as follows: (Stojkov, Nikolov, Smilevski, 2008)

a. Profitability and liquidity of the companies should not count on further fiscal stimulations, given that statutory tax rate was decreased from 15% in 2006 to 10% in 2008. Undertaking further reduction of the statutory tax rate could send a different signal to foreign investors instead of improvement of the business climate itself.

b. The latest data analyses of the tax declarations submitted to the Tax Administration (August 2008) emphasises the strong performance of Macedonian companies in terms of profitability. The flat tax policy measures have obviously been justified. Therefore, the flat tax system should continue to be aggressively advertised to potential foreign investors.

d. Further simplifications should be envisaged in terms of reporting made by taxpayers to the Tax Administration. Besides, tax administration procedures should be as much as possible simple, precise and with less bureaucracy involved.

e. A few months after the introduction of the flat system, a new 1.5% tax for small businesses on total income up to 3 million Denars annually has been enacted. A significant percentage of respondents in survey results attached strong resistance for such conflicting tax policy measures. Elimination or decrease of this tax rate in order to ease the tax burden for micro businesses must be considered.

f. The survey indicated mixed record for the reinvestment allowance incentive. This uncertainty shows reluctance for such incentive by the companies that are favoring the previous way of investment allowance. The simplification of such reinvestment incentive and reduction of the complexity is required in administering it. Another option is to replace it with more acceptable allowance for the companies, such as the accelerated depreciation for equipment.

g. Tax legislation is subject to changes too frequently. It is necessary to consider a rewording of the texts of the tax laws and preparing comprehensive texts which could contribute to more precise provisions and avoid further small and partial changes in the laws. The tax rules in Macedonia should be reconciled to those internationally recognized rules.

h. The Public revenue office must improve the audit performance and build a reputation of institution subject to less political influence and less corruptive elements. The politically independent approach would contribute to more efficient administering of the tax laws and greater capacity to deal with the new challenges of taxation, communication with other countries' tax authorities and harmonization with the EU Directives.

Free Trade Zones and Technological–Industrial Development Zones (TIDZs)

In Macedonia, the Law on Free Economic Zones was enacted in October 1999. Companies established in Free Trade Zones, which meet necessary qualification criteria, are entitled to receive the following benefits; (Ernst & Young, 1999)

- VAT exemption for products sold within the Free Trade Zone, or for products which are imported for processing and subsequent re-export;
- Profits tax exemption for 10 years;
- Property tax exemption for 10 years;
- General tax exemption on transfers of property and rights between founding parties and companies within the Free Trade Zone;
- Exemption from paying contributions, taxes and other duties for the utilization of urban land, connection to the water supply, sewerage, heating, gas and power supply network;
- Land may be leased for up to 50 years, with the possibility of an additional 25 year extension.

Because the EU regulations do not permit the establishment of free trade zones, Macedonian Government decided to develop Technological–Industrial Development Zones (TIDZs). These are centers in which highly productive manufacturing activities are concentrated and new technologies are developed. Macedonia offers additional incentives for development in the TIDZs, in addition to those normally associated with free economic zones.

Investors in TIDZs are entitled to personal and corporate income tax exemption for the first 10 years. Investors are exempt from payment of value added tax and customs duties for goods, raw materials, equipment and machines. Land in a TIDZ in Macedonia is available under long-term lease for a period of up to 99 years.

Other benefits include completed infrastructure that enables connection to natural gas, water, electricity and access to a main international road network. Investors are also exempt from paying a fee for preparation of the construction site. Fast procedures for business activity registration are provided in TIDZ that further reduce the costs of setting up.

The Government pays special attention to production activities, activities from the information technologies area, scientific research activity and new technologies with high environmental standards, for which additional benefits are envisaged in the TIDZs. Investors in TIDZs who operate in these areas are exempt from the liability of a guarantee for any customs debts.

Foreign Direct Investment

In Macedonia, FDI is permitted in all sectors of the economy, without any restriction. No restrictions are imposed upon the type of business in which a foreign company can invest, and no limitation is imposed upon the

amount of capital of a company in Macedonia that can be owned by a foreign person. Foreign companies can freely participate in privatization.

Foreign investors may receive same business opportunities as those available to local investors, including the right to operate in the TIDZs. In addition, foreign investors enjoy the same legal and regulatory protection as domestic ones. In order to conduct business in Macedonia, foreign company can own and acquire buildings, and has limited rights over immovable property.

In addition to having equal treatment as domestic investors, foreign investors in Macedonia are entitled to certain incentives, especially with regard to the payment of tax and customs duties. Profits tax reduction is available for the first three years following registration to companies with more than 20% foreign investment in their share capital. The potential profits tax reduction is calculated as proportionally to the amount invested by the foreign company in the new company. Equipment imported as foreign investment in a domestic company is also exempt from customs duties. There are also tax incentives for research and development expenditures.

Since 2006, Macedonia;

- Introduced a single procedure for trade licenses.
- Formed a Council for Adult Education .
- Established skill Needs Analysis model for short-term labour forecasts in 2006
- Preparation of new law on accreditation in accordance with EC Regulation No.765/2008 is underway.
- By end 2008, nearly 84% of municipalities had completed their cadastral registers-in contrast to only 46% in 2005.
- Implemented a simplified regime for SMEs and made further analyses for the tax burden.
- Leasing industry is well-developed.(Nolan, 2009)

Since property rights and their enforcement have a big impact on economic outcomes (Yeager, 1999, 33). Formal institutions have a big impact on economic outcomes. If property rights are not clear, and not easy to enforce, which is the case in Macedonia, this is a detrimental effect to growth. According to Yeager (1999, 33), the institutional framework of a nation ultimately determines the transaction costs, and therefore the degree to which an economy reaches its production and income potential.

Tackling the unemployment requires dynamic economic growth, adequate social policy, and fair distribution of income and resources. Macedonia, during the transition period has great problems with corruption. Since corruption is a rent seeking activity, which is a result from poorly defined property rights and non-efficient legal system, Macedonia needs a better enforcement ability of the laws.

Investment protection and liberalisation are key to successful government strategies to attract FDI. The private sector also has an important role to play to ensure good governance. In fact, the roles of the public and private sector were complementary and reinforcing. In the private sector, the accountability of managers, leadership, business ethics and long-term profitability can all mutually aid efforts by the public sector. Public sector efforts can focus on the legal and institutional framework for business and investors. An efficient and reliable judiciary, and the integrity of public administration, are two examples of how the public sector efforts can pave the way for efficient private sector activity.

All these instruments are part of a broad and comprehensive approach involving all actors in the investment process. Implementation, monitoring, and peer pressure are key tools for the effective implementation of these instruments, which can also aid in managing successful governance strategies in both the public and private sectors, in order to increase the investment opportunities in Macedonia.

As a result of a growing interest in Macedonia's investment potential, a number of international companies have started operations in the country, both as agricultural projects and through different types of asset acquisition and privatization.

Year	Foreign Direct Investments (in USD million)
2008	598.5
2007	699.1
2006	424.2
2005	97.0
2004	323.0
2003	117.8
2002	105.6

Table1: Foreign Direct Investments (FDI) Flow in Macedonia
Source: National Bank of the Republic of Macedonia

Table 1 shows the total FDI flows in Macedonia between 2002 and 2008. FDI flows have been affected by the global economic environment and financial crises that begins in 2008. In addition to that government dept crisis on Greece 2010 will reflect on this economies with the reason of cooperation's and mergers between companies.

Table 2 shows that the stocks of FDI in Macedonia by the country investors indicate that Netherlands, Hungary and Greece are the main portion on privatization and investment flows.

Country	% of total FDI stock on Macedonia
Netherlands	16.9
Hungary	16.6
Greece	15.2
Austria	9.4
Switzerland	6.6
Slovenia	6.5
UK	4.0
Germany	3.4
Luxembourg	2.8
Serbia	2.6
Other	16.0

Table2: Stock of FDI in Macedonia by country of investors, 1997-2007

Source: National Bank of the Republic of Macedonia

Table 3 indicates that manufacturing, transport and communications sectors had the main portion among the others. These two sectors cover 57 % of the total FDI in Macedonia.

Activity	% of total FDI stock
Manufacturing	35.6
Transport and Communications	21.3
Financial Intermediation	12.6
Trade and Repair	10.4
Electricity, Gas and Water	6.4
Real Estate and Business Activities	4.2
Construction	3.4
Hotels and Restaurants	2.1
Mining and Quarrying	2.0
Other	0.9

Table 3: Stock of FDI in Macedonia by activity, 1997-2007

Source: National Bank of the Republic of Macedonia

If we analyze the recent years the impact of the crisis on the financial sector has been relatively modest to date, mainly because banks rely primarily on domestic deposits to fund lending and deposit withdrawals have been limited. Strengthened banking supervision and adequate regulation have helped to maintain the stability of the sector.

Overall, banks remain well capitalized, including through continued support by overseas parent banks, and the capital adequacy ratio remained stable at 16.5 per cent after the first quarter of 2009. The public credit bureau increased its coverage and at the end of 2008 the first privately owned credit bureau was established.

The global financial crisis started affecting the economy in the fourth quarter of 2008, led by a decline in the output of the metal and textile sectors. The situation deteriorated in the first half of 2009 as industrial production contracted by 11 per cent compared with a year earlier, while foreign trade dropped sharply and foreign direct investment (FDI) roughly halved. The growth of GDP was -1.4 per cent in the second quarter of 2009, and unemployment remains high at about one-third of the workforce. At the same time, external imbalances increased, forcing the central bank to increase the reference interest rate from 7 to 9 per cent in March 2009 and repeatedly intervene on the foreign exchange market.

In response to the crisis, in November 2008 the authorities adopted an economic stimulus plan, which includes a number of fiscal measures such as rebates and write-offs of unpaid social security contributions, a further lowering of taxes on profits and agricultural incomes and a reduction of some import tariffs. As a result, fiscal policy has become more expansionary and after being in surplus during most of 2008. In March 2009 the government

presented a €8 billion investment program for the next seven years, focusing on large infrastructure projects in energy, transport, environment protection, education and culture.

The economy is likely to fall into recession this year as a result of a sharp drop in industrial output and exports. A more expansionary policy stance, reflecting the government's anti-crisis measures and the need to modernize the country's infrastructure, will result in a shift from modest fiscal deficits or surpluses of earlier years to higher deficits in the near future. The combination of lower exports, falling capital inflows (including FDI) and an expansionary fiscal policy have increased external risks, especially given the drop in reserves and relatively modest reserve coverage. These pressures, with weaker remittances, could necessitate a sharp contraction in imports, triggering a deeper and more prolonged recession.

	2004	2005	2006	2007	2008	2009
Privatisation revenues (cumulative, in per cent of GDP)	13.8	14.3	20.0	20.2	20.6	na
Private sector share in GDP (in per cent)	65.0	65.0	65.0	65.0	70.0	70.0
GDP	4.1	4.1	4.0	5.9	4.9	-1.6
Investment/GDP (in per cent)	21.4	20.7	21.9	24.2	na	na
Government balance	0.4	0.3	-0.5	0.6	-1.0	2.8
FDI (USD m)	323.0	97.0	424.2	699.1	598.5	na
Annual inflation (%)	-0.4	0.5	3.2	2.3	8.3	
Unemployment (end year)	37.2	37.3	36.0	34.9	33.8	na

Table 5: Economic indicators between years 2004-2009
Source:EBRD

On the other hand the recent rise in reserve coverage, as well as the government's commitment to fiscal discipline should help to mitigate these risks. Continued progress in the EU accession process is an important condition for the realization of Macedonia's medium-term growth potential.

Conclusion

In order to create new investment opportunities, Macedonian government have realized substantial institutional reforms and enhanced its legal capacity with the newly adopted regulations. With the implementation of new regulations to attract more FDI, Macedonia managed to get relatively a higher portion of foreign investment in comparison with the past.

The last financial crisis adversely affected the investment environment in Macedonia like the other South Eastern European states. The only way to solve the chronic problem of unemployment is to continue to implement the reforms decisively. In this sense, the implementation of legal provisions by the competent administrative bodies of this country has the crucial importance. The financial and economic integrations of the county with the global markets would also contribute to meet the conditions of the EU accession goal.

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