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## **Economic Development**

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***prof. Biljana Angelova, PhD***  
***Editor-in-chief***



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**Original scientific paper**

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**Violeta TASHEVA<sup>\*\*)</sup>**

## **THE INFLUENCE OF CULTURE'S VALUE SYSTEMS ON ENTREPRENEURSHIP IN THE REPUBLIC OF MACEDONIA**

### **Abstract**

This paper focuses on the *value dimensions of entrepreneurial culture* and discusses the impact of cultures' value systems on entrepreneurship. The main emphasis is on the impact of cultural norms and customs, religion and education system on entrepreneurship. The education system in the Republic of Macedonia and its impact on entrepreneurial culture will be discussed in details, hence conducting survey to analyse the views and opinions of students-graduates. The aim of the paper is to show that different cultural values affect the level of entrepreneurial culture. Education is a value that can have positive change, and indirectly change the culture that will promote and support the entrepreneurial spirit and entrepreneurial culture.

The educational process as an education of the population in a country has a significant impact on the creation of cultural values, beliefs and norms, and building national culture of society. Generally, it is considered that countries that invest more in education have higher rates of economic growth, since educated population is more productive. In Republic of Macedonia, the educational system is organized in pre-school education, primary, secondary, higher and adult education. Formal education is well organized and developed, with decentralized structure and high range of students. Exception to this is the adult education, which is in its initial stage of development. The development of this part of the education system will allow enhancing the competencies of people for their successful economic activity. Informal education does not have

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the real place in the education system, and there is a lack of system validation. Preschool education, which is developed in urban areas, is not yet mandatory education, and also there is lack of validation. Keeping in mind that cultural value systems are created in the early age of one's life, then the importance of this part of education and training is essential for building entrepreneurial spirit and culture in a society.

**Key words:** entrepreneurship, entrepreneurial culture, education, life - long learning, education, startup business, self-employed,

**JEL classification:** L26

### **Introduction**

Conditions in the economic, political, legal, social and cultural system of a country are not independent from each other on the contrary they are in constant mutual interaction. This interaction shapes the beliefs, norms and values in the country as cultural characteristics that define its national culture. Each country has its own culture, as a specific cultural model accepted by the people, and it is passed from generation to generation. The evolution of all these factors has a direct implication of the business within the country, region or the world.

According to Hofstade Geert, culture is the collective programming of opinion that distinguishes members of one group from another. Culture includes systems of values, and values are one of the constructive blocks of culture. Every person is "mind programmed" mostly during childhood, before adolescence. This stage of human life is known for its great capacity to absorb information from the environment: people and material environment. Today, the process of one absorbing information throughout one's life is known as learning. This process as part of the social reality has influence on shaping a person, group and society at large.

## **1. Cultural norms and customs**

A group of people who share a common set of values, beliefs and norms is said to be a society with its own culture. Values are abstract ideas about what the group believes to be good, right and desirable. They shape the culture by mutual interaction among people who share the same. Values influence political and economic systems of society.

Norms are unwritten, informal rules or orders, which define particular behavior in a given situation. Norms may be in the form of moral principles or folk customs. Moral principles are norms that result in serious penalties if broken. These include norms for condemnation of stealing, killing, lying, incest, cannibalism, the use of narcotics and alike. In many countries certain moral principles are embedded in legal legislation. Such moral principles influence on reducing the costs of doing business, which makes the situation suitable for entrepreneurial activities.

Folk customs define the way in which people are expected to behave as: appropriate dress code, good neighbourly communication, dining behaviour, appropriate behavior and alike. Violation of folk customs is not considered a serious precedent, but a personality trait such as ill-mannered, rude or eccentric.

## **2. Religion**

Religion has a great influence on shaping the value system of a society. It affects behavior, business etiquette and the relationships between people. According to Rakite, "Religion determines the moral code and ethics, creates taboos, directly or indirectly prescribes the behavior of people and their work habits."<sup>1</sup> The relationship between society and religion is complex, but the most important implications are on shaping the attitude toward work and entrepreneurship and the extent to which religious ethics affects the costs of doing business in a country.

Ethics is a set of moral principles, values and beliefs that people use to direct and shape the behavior as well or correct. Although ethical principles lead to the development of values, beliefs and norms to prevent certain entrepreneurial activities or encouragements, they can

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<sup>1</sup> Rakita Branko, "Medunarodni biznis i menadžment", Ekonomski fakultet-Beograd,2006, p.137

change or even disappear with change in beliefs and values. Many of the world's ethical systems are the product of religion. However, there is one exception to this, it is Confucianism and Confucius ethics that influences behavior and shapes culture, although it is not a religion.

Religion exists in different variants, from monotheistic to polytheistic. In monotheistic religions, the belief is based on one god, and polytheistic religions are based on the idea of the existence of multiple gods. Basic monotheistic religions are Christianity, Islam and Judaism, and basic polytheistic religions are Hinduism and Buddhism. In the Republic of Macedonia, and also in Europe and America, the monotheistic religion is dominant, while the polytheistic religion is dominant in Asian and African countries. Among the many religions that exist in the world, four are dominated by number of adherents: Christianity, Islam, Hinduism and Buddhism.

Worldwide, the number of adherents of Christianity is the largest, amounting to 1.7 billion people, or about 20% of the world's population. Christianity comes from Judaism, and it disperses through the centuries, but the major Christian religions are Orthodox, Catholic and Protestant. According to Weber<sup>2</sup>, the Protestant ethics emphasizes the importance of hard work, wealth creation for the glory of God and prudence or absenteeism from earthly pleasures. He argued that the Catholic promise of salvation in the next world did not encourage same kind of work ethics. The emphasis on individual religious freedom of the protestant religion as opposed to Catholicism, is a positive impulse for individual economic and political freedoms and the development of individualism as a philosophy. This philosophy supports the market economy and entrepreneurship activities, and thus economic growth and development. Great Britain, Germany and the United States are nations with a strong Protestant tradition.

Islam, with almost one billion followers, is the second largest religion in the world. It has its roots in Judaism and Christianity, and it began in the year 610 AD when the prophet Muhammad began to preach his doctrine. Islam requires unconditional acceptance of the uniqueness, power and authority of Allah, and throughout life people need to fulfill his will, hoping to be admitted into heaven. Economic implications of the Islam, according to the Koran, are directed towards free entrepreneurship and legitimate profit through trade and commerce (the Prophet

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<sup>2</sup> Weber, M., *The Protestant Ethic and the Spirit of Capitalism*, New York: Charles Scribner's Sons, 1958. p.35

Muhammad was a merchant). Property rights protection is also incorporated into Islam. Islam supports social justice, emphasizes the importance of compliance with the contractual obligations, keeping the word, abstinence from fraud and criticizes earning profits by exploiting other people.

Hinduism is a polytheistic religion, and it has approximately 750 million followers. It is the oldest religion in the world, and it occurred in India more than 4000 years ago. Hindus believe that the moral power in society requires the acceptance of certain responsibilities (karma), they believe in reincarnation after death and karma. With the improvement of the soul in each subsequent life the individual can achieve nirvana, a state of complete spiritual perfection, upon which there is no need for reincarnation. They believe that the way to achieve nirvana is to have a harsh ascetic life with material and physical deprivations, and dedication towards spiritual rather than material need. Weber argues that the ascetic principles rooted in Hinduism do not encourage entrepreneurial activity in search of wealth creation. Hill Charles, for today's modern India, the cradle of Hinduism, says, "India is a very dynamic entrepreneurial society and millions of hard-working entrepreneurs build the economic backbone of India's rapidly growing economy".<sup>3</sup>

More than 200 million people in China, Korea and Japan still follow the ethnic system of Confucius. Confucianism occurred in the fifth century BC as a dogma about the importance of achieving personal salvation through right actions. Although Confucianism is not a religion, this ideology remains deeply planted in the culture of these countries, through the ethical system which sets the guidelines in the relations between people, and it is focused on high moral and ethical conduct and loyalty to others. Economic success in China, Japan, South Korea and Taiwan is believed to be influenced by Confucianism ethics, thus reducing the cost of doing business in those countries. In this sense, values central to Confucianism are loyalty, reciprocal obligations, and honesty in the relationship with others. In this culture, loyalty is emphasized in value systems, and for it a "blessing" is expected. The concept of reciprocal obligations is also important, as it is used to create network connections - "guanxi", through which the reciprocal obligations are maintained. Honesty in Confucianism is highly appreciated, and it has major economic implications. It is a guarantee that

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<sup>3</sup> . . . , , , ,2010, .104

contractual obligations will not be violated, hence reducing the costs of doing business.

### **3. Educational system**

The educational system represents a part of the global social system with complex structure and numerous interactions among its elements and its environment. As a complex system, it incorporates relationships and processes that are important for the country, such as: educational policy, organization and structure of the system, a content - program structure and alike. The existence of subsystems for formal, non-formal and informal education indicates the complexity of the education system.

The educational process as an education of the population in a country has a significant impact on the creation of cultural values, beliefs and norms and on building national culture of the society. Keeping the pace with new technological and socioeconomic achievements requires not only primary-formal literacy of the population but also continued education for skilled people who will be competitive in the labor market. Schools usually teach basic facts about the social and political nature of society. Respect of others, obedience to authority, honesty, neatness, accuracy, etc. are part of the "hidden curriculum"<sup>4</sup> of schools. The evaluation system also teaches children the value of personal achievement and competition. Formal education plays a key role in the creation of values and norms in society that are transmitted by direct and indirect means, and it teaches individuals most of the linguistic, conceptual and mathematical skills that are necessary in a modern society. "Formal education substitutes the role of family in socialization of youth in values and norms of a society."<sup>5</sup>

In the contemporary economic analysis, the category of human capital as a factor of economic development is introduced. According to Dimitar Eftimovski, "Human capital is defined as a set of production skills, talent and knowledge of the individual"<sup>6</sup>, and its value can be evaluated by the value of goods and services.

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<sup>4</sup> Goodman N., *An Introduction to Sociology*, New York Harper Collins, 1991, str.11

<sup>5</sup> .....op.cit., .110

<sup>6</sup> ..... .20

Education is an activity through which human capital is acquired by the individual and society as a whole, and it impacts the economic and human development. On the other hand, quality economic growth entails the creation of new jobs; If this is not achieved then people are not able to develop their capabilities, which directly affects the quality of their lives. Measures to overcome this issue usually relate to "increased investment in human capital and development of labor-intensive industries".<sup>7</sup> The first measure is directed towards a rise in overall labor productivity, and the second measure towards a reallocation of human capital. Generally, it is believed that countries that invest more in education have higher rates of economic growth, since *educated population is more productive*.

"In 1960, Pakistanis and South Koreans were economically equal. However, only 30% of Pakistani children were enrolled in primary education, while in South Korea, this percentage was 94%. By the middle of the eighties the gross national product of Korea was three times higher than that of Pakistan".<sup>8</sup>

### **3.1. Educational system in the Republic of Macedonia**

The educational system in the Republic of Macedonia is in accordance with the national cultural values, with a tendency to meet the characteristics of the country's political and economic system, the needs of people and modern trends in this area. Values that are expected in the Republic of Macedonia, and are set out in the National Programme for the Development of Education 2005-2015, are described as "social, cultural, physical and intellectual well-being of the citizens. In this regard, the development of competent, creative, citizen-oriented and ethically developed human capital in the spirit of modern civilization values, such as: knowledge, democracy, fairness, tolerance and humanity. Moreover, within the frames of set goals, seeks to follow the basic principles underlying the development of education in Macedonia such as: quality, civil responsibility, connection with the labor market, economy, fairness, transparency and integrity".<sup>9</sup>

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<sup>7</sup> *ibid.*, .275

<sup>8</sup> "What Can the Rest of the World Learn from the Classrooms of Asia?", *The Economist*, 21 september, 1996, p.24

<sup>9</sup> National Programme for development of education in Republic of Macedonia 2005-2015, MON-Skopje, 2000

The educational system is organized into subsystems of preschool education, primary, secondary, higher, lifelong learning and special education. Preschool education is an initial degree and a basis of the education system, where the activities are carried out in pre-schools, kindergartens, covering children from all backgrounds, social groups and age to 6 years. According to SSO<sup>10</sup>, in 2010, in the country there are 54 public institutions for care and education of children - kindergartens, which included 23,157 children of all ages, of which 21,825 children studied in Macedonian language, 1,120 children in Albanian, 63 children in Turkish and 149 children in other languages.

According to SSO<sup>11</sup>, in 2010/11, there were 990 regular primary schools with 204,439 students which compared to 2001/02, when there were 244,740 students, is a decrease in the number of students, and this reduction is continuous over the past 10 years. According to the demographic trends this is expected to continue.

The amount of students in terms of the total population of the same age from 7-14 years was 95.75% in 2000/01 and 91.41% in 2009/10. In secondary education in 2010/11, there were 111 regular high schools that included 94,155 students, which in comparison to 2001/02, when there were 95 schools and 92,554 students, is an increase in the number of students continuously over 10 years. The amount of students in terms of the total population of the same age from 15-18 years was 62.96% in 2000/01 and 69.78% in 2009/10. Secondary education is conducted in public and private secondary schools, where 40.4% of students study in secondary schools and 59.6% in vocational schools.

The secondary vocational education is organized as 3 and 4 years, with the participation of students 5.8% and 94.2% respectively. In the school year 2009/10, there were 6 post-secondary vocational schools and 2,102 students, while in higher education there were 101 colleges and 55,792 students. Overall, in third-cycle education there were 57,894 students, of which 1,177 students (about 2%) were from other countries (Serbia, Montenegro, Croatia and other countries)<sup>12</sup>. At postgraduate studies there were 3,227 students, of whom 104 students (3.2%) from other countries (Serbia and other countries)<sup>13</sup>. Adult education is regulated by law since 2008. In this subsystem, reform efforts are being

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<sup>10</sup> Announcement no. 2.1.11.01 of 24.02.2011, Skopje

<sup>11</sup> SSO, Primary and secondary schools at the beginning of 2010/2011, 2.4.11.04.683, Skopje, July 2011

<sup>12</sup> SSO, Enrolled students in academic 2009/2010, no. 2.4.11.11.694, Skopje, 2011

<sup>13</sup> SSO, Enrolled students at postgraduate studies in 2009/2010, no. 2.4.11.11.694

made for its systematic and active improvement. For now, the activities undertaken in adult education are minimal<sup>14</sup>.

#### **4. Entrepreneurship in the education system in the Republic of Macedonia**

The educational system in the Republic of Macedonia recognizes that entrepreneurial education is a challenge. The educational programs are created in the context of connecting entrepreneurial training to small and medium-sized enterprises, employment and research and development. Entrepreneurial education is embodied in the National Strategy for the Development of Education 2005-2015, the Law on Secondary Education, the Law on Vocational Education and Training, the Law on Adult Education and other documents and acts.

Entrepreneurship education began to be implemented through pilot projects in primary, secondary and higher education. In 1997, Junior Achievement (JA)<sup>15</sup> program was introduced to primary school students from 7 to 14 years old in order to encourage entrepreneurial spirit among students in 43 primary schools or 13% of the total number of primary schools, of which 25 in Skopje. The number of active students is around 11,000 or 5% of students in primary education.

The World Bank Project and the Ministry of Education enabled capacity building of teachers in primary and secondary education through entrepreneurial education training. Within the Education Modernization Project, 336 teachers from 31 primary schools participated in classroom management training, communications and the like. The project of the Government of the Republic of Macedonia, "Computer for Every Child", facilitated the development of entrepreneurship in order to improve information technology in the primary and secondary schools.

Entrepreneurship, under the Oslo Agenda for entrepreneurial learning<sup>16</sup> should be formally included in primary schools curriculum. This should incorporate introducing innovative methods of teacher training such as: inter-active methods, case studies, methods based on which teachers are involved in the real world of business, also more

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<sup>14</sup> Labor force survey – 2009, no. 2.4.10.04/651, July 2010, Skopje

<sup>15</sup> Junior Achievement(JA): [www.jamacedonia.org.mk](http://www.jamacedonia.org.mk)

<sup>16</sup> [http://ec.europa.eu/enterprise/entrepreneurship/support\\_measures/training\\_education](http://ec.europa.eu/enterprise/entrepreneurship/support_measures/training_education)

flexible teaching and learning arrangements in order to promote initiatives, creativity, innovation and risk taking.

In secondary and vocational education for students from 14-18 years additional programs for introduction to entrepreneurship are introduced. Junior Achievement in 42 secondary schools with custom-made curriculum. The implementation of CARDS programs, Vocational education program-VET1, VET2, VET3 and VET4 of FARE Program has started since 1998 with an aim to restructure the educational system for entrepreneurial skills in society. These projects included 56 high schools across the state. Within these projects, training of teachers and staff at the Center for Vocational Education and Training (VET) has been carried out. The Centre aims to integrate entrepreneurship in the program documents of VET.

Also, in the period from 2003-2004, the project GTZ-VET was implemented and aimed at restructuring the vocational education system by reforming the curriculum and the syllabi. Within the project of modernization of education, 261 teachers from 12 secondary schools selected classroom management training, communications and the like. SEA project included 71 school where Career Centers were equipped with necessary computer and audio-video equipment, in which students receive information about the labor market and opportunities for continuing their education.

As part of the project Strengthening Entrepreneurship, Competitiveness and Innovation (SECI) training was conducted for teachers who teach the subject entrepreneurship and business in high schools and art schools. British Council implemented the program "Business without Borders", which included students from 10 high schools and students from the Faculty of Mechanical Engineering, about 200 participants who followed the 7-day training and then created a business plan for their ideas.

USAID Activities in secondary education project, through established Career centers (50 schools) and school virtual or real companies (23 schools), aims to improve students' personal and professional competencies to enhance their employability. ECO NET Culture Contact project, from Austria, in cooperation with CSOO supported training in entrepreneurship and business of teacher from economic, legal and commercial vocation schools involved in virtual training companies.

Today, entrepreneurial learning is an integral part of the curriculum in the fourth year in: gymnasium and arts education; four-year vocational education, in all profiles in the third and fourth year; and vocational schools in economics, legal and commercial vocation, in each school year, as well as the subject school company as a form of practical education with 4 and 6 hours per week.

Entrepreneurship in higher education is taught as an elective. Postgraduate studies in entrepreneurship as a major is offered only by the Institute of Economics-Skopje.

## 5. Survey

A survey has been conducted in order to consider the impact of secondary education on students' value system in the Republic of Macedonia, in context of entrepreneurship.

**The overall objective** of the research is aimed at the identification of entrepreneurial culture among students in the final years of secondary gymnasium, art and vocational education.

**The specific objectives** are aimed at: identifying the impact of compulsory education on entrepreneurial culture among students; identifying the impact of value system of culture on entrepreneurship among students.

**Methodology** - The survey of entrepreneurial culture among students in their final years in high gymnasium, art and vocational education will reflect different levels of entrepreneurial cultural values among them.

**The sample** is composed of students in secondary gymnasium, art and vocational education. The survey was conducted on a sample of 536 students in their final years of secondary high school, art and vocational education. Out of 536 students, 62 students are in their final third year of VET (11.6%), and the remaining 474 students in the final fourth year of secondary gymnasium, art and vocational education (88.4%). According to sex, 267 are men and 269 are women. According to age, all respondents are in the group 15-24 years.

The survey was conducted in 20 schools in different regions of the country in order to cover a wider territory. The survey was conducted in one class in each school, which included secondary gymnasium, art and vocational training in different vocations. The frequency in terms of

vocation, schools, cities and number of participants - high school students in the Republic of Macedonia, is shown in Table 1.

**Results of the survey-** The survey was conducted in September and October 2011, using a questionnaire<sup>17</sup> developed for this purpose containing 40 questions. The questionnaire was used to identify the entrepreneurial culture among students in the final years of secondary high school, art and vocational education.

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<sup>17</sup> Adapted according to: European Commission, Entrepreneurship in the EU and beyond, A survey in the EU, EFTA countries, Croatia, Turkey, the US, Japan, South Korea and China, Analytical report: Directorate-General for Enterprise and Industry, Brussels, 2009

**Table 1. Surveyed participants according to vocation, school and city**

vocation	school	city	students
Health	Dr. Pance Karagozov	Skopje	31
Electrotechnical	Vlado Tasevski	Skopje	29
Forest and wood processing	Gorgi Dimitrov	Skopje	28
Economics, legal and trade	Arsenie Jovkov	Skopje	30
Traffic	Boro Petrusevski	Skopje	29
Gymnasium	Pance Arsovski	Skopje	27
Mechanical	8 September	Skopje	22
Constuction and construction surveying	Zdravko Cvetkovski	Skopje	25
Textile and leather	Vanco Prke	Vinica	27
Mechanical	Mirko Mileski	Kicevo	26
Agriculture and Veterinary	Mosa Pijade	Tetovo	28
Health	Gostivar	Gostivar	28
Catering and tourism	Naum Naumovski Borce	Krusevo	26
Chemical and technological	Niko Nestor	Struga	25
Gymnasium	Dr. Ibrahimo Temo	Struga	26
Economics, legal and trade	Ljupco Santov	Kocani	26
Electrotechnical	Gorce Petrov	Kriva Palanka	27
Food	Ss. Cyril and Methodius	Negotino	26
Geological, mining and metallurgical,	Kosta Susinov	Radovis	27
Music	Sergej Mihajlov	Stip	23

The questions referring to entrepreneurial culture include the following sub-groups:

1. Self-employed vs. employed
2. Possibility to become self-employed
3. Image of the entrepreneur in society
4. What would you do if you inherited a substantial amount of money

5. Entrepreneurship and business activity
6. Business start-up, important factors
7. Business start-up, risk perceptions and barriers
8. Influence of education on entrepreneurship

**Data analysis** is quantitative and qualitative. The quantitative analysis is conducted based on data obtained from the survey. Qualitative analysis of the survey will be presented in each of the eight sets of questions.

**I group: Self-employed vs employed;** Of all the participants surveyed, 56.3% chose self-employment, of whom 54% were men. According to place of residence, the majority of participants (41.4%) who prefer self-employment are from city, according to the economic status of their parents, in most cases (44.4%) one of the parents is self-employed and the other is employed, according to the financial situation, the majority (46%) reported most comfortable / comfortable. Of all the participants-Macedonians surveyed, about 62.5% reported self-employment, of the Albanians 39.5%, Serbs 61.1%, Turks 68.4%, Romas 21.4%, Bosnians 72% and Vlachs 9%. Out of all participants-Orthodox surveyed, 62.4% reported self-employment, Muslim 43.1%, and Protestant 50%. All respondents-Catholic and Jew opted for employee status.

As key reason for indicating self-employment, 42.5% of students emphasized personal independence, 59.6% of them being women. About 19% of the students-participants selected higher income as most important reason for self-employment, and of these 53.9% were men. Participants of all nationalities prefer personal independence over higher earnings, except Vlachs and Roma who chose opposite. According to religion, all participants prefer personal independence over better earnings, with the exception of Catholics and Protestants.

As key reason for preferring employment, 43.8% of students-participants emphasized regular fixed income, of these 54% are men. About 15.8% of the students selected stability of employment as key reason for employment, 61.2% of them being women. Students of all nationalities and from every religion prefer to be employed due to regular income, except the Protestants who apart from the regular income prefer stability in employment as well.

**II group: Possibility to become self-employed;** The possibility to become self-employed within the next 5 years was reported by 65.7% of students, of whom 53.7% were men and 46.4% women. According to the nationality of the students, positive attitude towards self-employment have: Macedonians 67.1%, Albanians 77.8%, Serbs 66.7%, Turks 52.6%, Bosnians, 56% Romas, Vlachs 54.5% and Romas 50%, as well as all participants according to the religion.

Lack of capital was determined as primary obstacle for the viability to become self-employed according to the majority of students (40.5%), regardless of their nationality. Out of them 49.3% are men and 50.7% are women. The same point of view is shared by more than half of students with Orthodox and Muslim religion.

**III. Image of the entrepreneur in society:** Most of the students (72.4%) of all nationality and religion, said that entrepreneurs create new products and services from which people have benefits. The majority of these students are men, 50.8%.

66.8% of students, most of whom are women (50.3%) believe that entrepreneurs are self-oriented, whereas 73.3% of students, most of whom are women (51.7%) consider entrepreneurs to be creators / designers of work. 59.5% of students, most of whom are men (55.5%) believe that entrepreneurs exploit other people's work. These positive attitudes are shared by more than half of the students, of all nationalities and religion, with the exception of Protestants.

About 43.7% of participants-students have positive view of entrepreneurs, out of which men and women have about the same share. Impartial position is shared by 46.6% of students. Most students Albanians, Turks, Romas, Bosnians and Vlachs have a neutral stance on this issue. The number of students Macedonians who reported positive attitude towards entrepreneurs is the same as the number of students who reported impartiality. Most of the students Muslims recorded neutral position, and most Orthodox and Catholics reported positive on entrepreneurs.

Regarding other professions, most of the students have positive attitude towards the liberal professions, fewer of them towards top managers, much less towards bank managers. For civil servants, most of the students have a neutral position according to nationality except Romas, whose position is "quite well". According to religion, most of the Orthodox and Muslims have an impartial stance, except Protestants who

have a negative attitude towards civil servants. Regarding politicians, the majority of students reported negatively, out of which the number of women is greater than the number of men. According to nationalities, all reported "quite poor" about politicians, except Turks and Vlachs. According to religion, all students, except Catholics and Protestants, have a negative attitude towards politicians.

**IV. What would you do if you inherited a substantial amount of money;** In case one inherited a substantial amount of money most of the students would start a business (44.4%), most of them being men who support this position. Starting a business was reported by Macedonians, Albanians, Serbs, Turks, Roma, and Bosnians. Also, most of those who reported starting a business were Orthodox and Muslims. On the other hand, savings were first option for the second largest group of students (28.7%), most of them being women.

**V. Entrepreneurship and business activity;** Experience in starting business activities have 26.7% of the surveyed students, whereas 72.2% do not have any experience. Most male students have experience in starting a business, close to 2/3. Students who have no experience at all are predominantly women, nearly 60%. Of the total number of Orthodox students only 23.8% reported that they have experience in launching business activities, Muslim 34.3%, Catholic 1/3, Protestants 1/2. According to nationality, students who have experience in starting business activities are Macedonians 23.2%, Albanians 35.2%, Serbs 44.4%, Turks 26.3%, Romas 31% Bosnians 32% and Vlachs 18.2%. Most students, regardless of their nationality and religion, said that they intend to start a business (49.8%), the majority of whom are men, followed immediately by those students who never intended to start a business (28.4%), most of whom are women.

**VI. Business Start-up, important factors;** Dissatisfaction with the previous condition among majority of students (53.4%) has a very important impact on reaching a decision to start or take over a business, and rather important impact among 22.2% of the students. Approximately 83% of the students reported the importance of the impact of having an appropriate business idea on starting a new business or taking over an existing one, out of which among 45.7% it has a very important impact, and quite important among 37.3%. Contacts with

appropriate business partner in starting a new business or taking an existing one has an impact among majority of students (82.5%), of which 44.6% reported very important impact and quite important in 37.9%. Approximately 91% of the students reported the importance of providing necessary capital to launch a new business or taking over an existing one, and of these among 64.9% it has a very important impact, and quite important among 26.1%. Not met social and environmental needs to start a new business or take over an existing one has an impact among majority of students (74.6%), of which among 30% it has very important impact. These attitudes among students are independent of their ethnicity, religion and gender.

Examples of good business decisions have great influence among 86.2% of students to start a new business or take an existing one, and of these very important impact among 39.7%, and quite important among 46.5%. This opinion is held by students regardless of their nationality and religion. This issue is "very important" among men as well as women, and "fairly important" among the majority of women.

Approximately 50.4% of surveyed students reported that, if they have sufficient capital, they would start a new business, and 31.3% reported that they would take over an existing one. This position is held by majority of students regardless of their ethnicity, religion and gender. Most students (83.8%) believe that business should be run "slowly but surely" and only 13.8% have chosen rapidly expanding business. Again, this position is held by students regardless of their ethnicity, religion and gender. 36% of the students reported that they started or start a business as a result of an opportunity, and 18.3% of the students started a business because they needed to. Most of the students (41.2%), mainly Macedonians, Roma and Bosnians, reported that both things are important, whereas for Albanians and Turks having an opportunity is the reason for a start-up. Most Serbs start a business as a result of a need, while for the majority of Muslims starting a business is due to an opportunity, and most of the Orthodox believe that both are important for start-up business. Also, most male students start a business due to an opportunity, and most women find that both opportunity and necessity are important for start-up business.

**VII. Business start-up, risk perceptions and barriers;** For majority of students income uncertainty and the possibility of bankruptcy are ponited as greatest risks that make students reluctant about starting a business,

where male students are more fearful about income uncertainty and women about both. Among Macedonians, Albanians, Bosnians, Orthodox, Muslim, Catholic and Jew the primary risk is related to the uncertainty of revenue and the second risk to the possibility of bankruptcy.

The opinion that it is difficult to start a business when there is lack of sufficient capital is shared by most of the students (89.2%), most of them being women. Most students of both sexes (77.3%) believe that it is difficult to start a business due to complex administrative procedures. Also, 53.2% of the students think that it is difficult to find enough information to start a business and 45% disagree with this view, where the positive attitude is held by most men, and the negative attitude by most women. 86% of students, most of whom are women, believe that people who started their own business and experienced failure should be given a second chance. This opinion is held by students regardless of their nationality and religion.

The majority of students (56.9%), most of them being men, believe that a business should not be started if there is a risk of failure. Most of the Macedonian, Albanian, Turk, Roma, Orthodox, Catholic and Muslim students supported this view, while the majority of Serbs, Vlachs, Bosnians and Jew reported negative attitude towards this view. Equal share of Protestants responded positively and negatively to this issue.

**VIII. Influence of education on entrepreneurship;** Most of the students (80.6%) believe that education helps develop a sense of initiative. About 83.8% of students, most of them being women, reported that education helps to better understand the role of entrepreneurship. About 69.2% of students, most of them men, believe that education provides the skills and knowledge to conduct business. These opinions are held by students regardless of their nationality and religion.

Regardless of their ethnicity, religion and gender, most of the students (63.6%), said that education creates interest to become an entrepreneur. Exception to this are Bosnians most of which do not agree with this view, as well as Jews.

## **Conclusion**

Each country has a different model of political, economic, legal, social and cultural systems and their complex impact has significant implications on the benefits, costs and risks associated with doing business, manner of doing business, as well as the business strategy. In order for one country to be open to innovation and entrepreneurial activity it is necessary the business environment to highlight the advantages of the market economy, the property rights protection, intellectual property protection, ethics in business activities and functional and mature democracy. Democratic countries build legal systems that protect property rights, thereby encouraging entrepreneurship. Private property encourages dynamic competition and economic efficiency, it provides entrepreneurial profits. Corruption discourages investment, weakens the economic vitality, leads to lower growth and makes the country unattractive for business ventures, thereby discouraging entrepreneurial activities. Developed countries usually associate representative democracy with a market economic system, strong protection of property rights and economic progress. Strong environment for support and development of entrepreneurial activities is generated if there are easy, simple and fast communication, behavioral preference for informality, dedication to work as the purpose and meaning of life, respect for gender equality, and monochrome orientation to time and especially positive attitude to youth.

Norms are social rules that govern the actions of people in mutual interaction, these are guidelines that prescribe appropriate behavior of the people, they can be manifested in the form of moral rules and folk customs. Adherence to norms reduces the cost of doing business, and societies where norms are clearly outlined encourage entrepreneurial activities.

The relationship between society and religion is complex and the implications on shaping the attitude toward work and entrepreneurship affects the cost of doing business. It is believed that individual religious freedom of the protestant religion in relation to Catholicism and Orthodoxy is a positive impulse for individual economic activities, supports entrepreneurship and market economy. The economic implications of Islam, is in the direction of free entrepreneurship and earning legitimate profit through trade and commerce. Ascetic principles embodied in Hinduism do not encourage entrepreneurial activity in

search of wealth creation. It is believed that Confucianism ethics positively affects economic success, because of the ethical system, which sets the guidelines in the relations between people, and it is focused on high moral and ethical conduct and loyalty to others, thereby reducing the cost of doing business.

Entrepreneurial education is not part of the mandatory school curriculum in primary education. Entrepreneurship can be found only in elective courses and additional activities. Three-year vocational education does not have reformed curriculum and with lack of syllabus and courses in the area of entrepreneurship. Also, pilot entrepreneurial education and training programs are not enough, that is, complete implementation especially in the three-year vocational education is necessary which will allow students to be prepared for a job or economic activity. In higher education there isn't undergraduate programme in entrepreneurship, although the number of university institutions increases.

In order to consider the impact of compulsory primary and secondary education on students' value system, in the context of entrepreneurship, a survey was conducted among students in the final year of secondary three- and four-year education in the state.

**The analysis** shows that 56.3% of surveyed students prefer to be self-employed rather than employees, most of them being men and come from an urban environment. More than half of the students of all nationalities chose self-employment, with the exception of Albanians, Romas and Vlachs. According to religion, more than half of the Orthodox students prefer to be self-employed, as opposed to Muslim students. Personal independence is a reason for self-employment among largest number of students, most of whom are women. The second reason for self-employment is better earnings among student, most of whom are men.

Students of all nationalities prefer personal independence over better earnings, except for Vlachs and Romas who reported the opposite. According to religion, all students prefer personal independence over better earnings, except for Catholics and Protestants.

Approximately 65.7% of surveyed students, most of them men, believe that in the next 5 years there will be an opportunity for them to become self-employed. This opinion is held by students regardless of their nationality and religion. Lack of capital is pointed as a major obstacle to the intention of becoming self-employed by most female

students. Same view is shared by more than half of students with Orthodox and Muslim religion.

Positive attitude towards entrepreneurs is held by 43.7% of students and neutral by 46.6% of the surveyed students. Most students Albanians, Turks, Roma, Bosnians and Vlachs have a neutral attitude towards entrepreneurs, while Macedonians have reported both positive and neutral entrepreneurs. Most of the students Muslims declared neutral attitude, and most Orthodox and Catholics reported positive for entrepreneurs. More than half of the students surveyed believe that entrepreneurs create new products and services for all and are creators of the work, but also more than half of the surveyed students have the attitude that entrepreneurs only think of themselves and exploit other people's work. These opinions are shared by more than half of students of all nationalities and religion, except Protestants. Most women think that entrepreneurs are creators of the work and think only of themselves, and most men think that entrepreneurs create new products and services for all and take advantage of other people's work.

Compared to other occupations, most of the students expressed positive attitude for liberal professions (architects, lawyers, actors, etc.), less for top-managers and managers of banks and civil servants, and for politicians more than half of the surveyed students reported negative opinion. These attitudes are regardless of students' nationality, religion and sex.

In case of inheriting a significant amount of money, most male students would start a business, while most female students would save money. Of all surveyed students only 26.7% have experience in starting a business, most of them being men (2/3). Muslim students have more experience in starting a business (34.3%) over Orthodox students (23.8%). Albanians, Bosniaks, Roma, Turks and Serbs have greater experience in starting a business over Macedonians and Vlachs. Starting a business is considered by 49.8% of students, most of whom are men.

Dissatisfaction with the previous state, an appropriate business idea, contact with the appropriate business partner, necessary funds, and unmet social or environmental needs are reported to have greatest impact on the decision to start a business by more than half of the surveyed students, regardless of nationality, religion and gender, whereas examples of good business have more impact on women.

Most of the students surveyed prefer starting a new business over taking an existing business and it should be taken slowly but surely. 36%

of the students surveyed thought that an opportunity is a reason for business, and only 18.3% that it is a need, and most of the students (41.2%) believe that both are important for starting a business.

Income uncertainty and the possibility of bankruptcy are reported as the biggest obstacles to starting a business. This attitude is shared by Macedonians, Albanians, Bosnians, Orthodox, Muslims, Catholics and Jewish. Lack of financial support, complex administrative procedures and lack of information on business start-up are obstacles that have been reported by a great number of students, regardless of nationality, religion and gender. A number of students also believe that a business should not be started if there is a risk of failure, and most of them are men, Macedonians, Albanians, Turks, Roma, Orthodox, Catholics and Muslims. 86% of students, most of them women, believe that a second chance should be given to people who have started their own business and experienced a failure. This attitude is held by students regardless of their religion or nationality.

More than half of students believe that their school education has an impact on the development of the sense of initiative, a better understanding of the role of entrepreneurship in society, offers skills and knowledge for doing business and creates an interest in becoming an entrepreneur. Attitudes that their school education has an impact on the development of sense of initiative, creating interest to become an entrepreneur and a better understanding of the role of entrepreneurship, is held by most of the women, whereas the opinion that it provides the skills and knowledge to conduct business is held by most of the men. These attitudes among students are regardless of their nationality and religion.

***The analysis shows that the surveyed students have different cultural values regarding entrepreneurship. Influence of the value system of religion on entrepreneurial attitudes vary depending on nationality and religion, gender, place of residence, economic activity of parents and financial capabilities.***

Positive entrepreneurial attitudes are held by men coming from urban environment, living comfortably, at least one of the parents is self-employed, and based on nationality they are Macedonians, Serbs, Turks and Bosnians, and most of them are Orthodox. The impact of education on entrepreneurial attitudes is confirmed in 2/3 of the respondents. Most women think that school education has an influence on the development

of the sense of initiative, creating interest to become an entrepreneur and allowing a better understanding of the role of entrepreneurship. While most men think that education provides the skills and knowledge to conduct business. These attitudes among respondents do not depend on their nationality and religion. The survey results confirm that the life-long learning is a factor for building an entrepreneurial culture in a society.

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**Original scientific paper**

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**THE SIGNIFICANCE OF KNOWLEDGE MANAGEMENT IN  
THE REPUBLIC OF MACEDONIA – TRADITIONS AND  
CHALLENGES**

**Abstract**

The strongest economies in the world are economies based upon knowledge. Nowadays, their survival depends solely upon creating, spreading, accepting and applying knowledge – complex processes which require effective management. Usually, knowledge management is the most important part of human resources management in every organisation, both public and private.

To Macedonia, which has a need of strong economic growth and positioning in the intensely competitive world economy, knowledge management holds a great significance. The subject of this paper, via empirical research, is the determining of the current condition and the challenges in this field. In Macedonia, the key factors for recognising and implementing the knowledge management process are the organisational culture and the operation style of the managers – factors which still have not received the necessary attention in the two-decade long process of transition towards a market economy. The research conducted expectedly shows that people are not acquainted enough with the concept, that some of its elements are intuitively applied and that the awareness that it is needed is rising. Therefore, it is necessary to take steps for realising a competitive advantage in the changeable business environment:

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**Key words:** knowledge management, lifelong learning, innovation, competences, organisational culture

**JEL Classification:** D83

### **Introduction**

The countries in the European Union are societies based upon knowledge. Nowadays, their survival depends solely upon creating, spreading, accepting and applying knowledge. The new trends – fast change and rapid development of technology, mean that gained knowledge grows obsolete rapidly, hence lifelong learning remains a foundation stone of the modern strategy for education. The time of knowledge does not allow improvisation and so it follows that education is one of the most important political priorities of the European Union.

The managers in the European Union realise that in order to survive in a complex and dynamic atmosphere, the organisations have to be flexible and quick-reacting. Gaining knowledge, skills, and abilities as an uninterrupted continuous process results in a healthy economic competition and prosperity – a guarantee for becoming a part of the global trends. Using the most modern methods and the achievements in technology for the sake of learning and gaining knowledge to have a suitable goal and a precise application is important as well. The knowledge management is particularly significant and seriously accepted at all levels of organisation by the European Union managers, not as a luxury, but as a necessity. It can be said that the significance of the knowledge management, despite minimising losses and risks, is in the fact that it improves the organisation and its effectiveness; it instigates innovation and initiative on the part of the employees due to creating bigger values in the organisation.

Taking the global competition and the rising dynamics of the business environment into consideration, organisations are advised to employ people with different talents and to make use of their expertise for gaining access to new technologies and entering new markets. When speaking of a relatively new science, one always starts from its roots – the foundations upon which it rests. Knowledge management is one of

those new sciences, which is propelled into the focus of society's interest by a couple of factors<sup>1</sup>:

- Raised awareness for the increasingly larger significance of knowledge in the world;
- Initiating and accepting global tendencies and competitions;
- Information society and the need for faster development.

Gaining knowledge, skills, and abilities as an uninterrupted continuous process results in a healthy economic competition and prosperity – a guarantee for becoming a part of the global trends. Using the most modern methods and the achievements in technology for the sake of learning and gaining knowledge to have a suitable goal and a precise application is important as well, especially when being aware that knowledge is a basic value in the society and a precondition for success. However, in many situations, the gained and accumulated knowledge is unusable or, as P. Senge<sup>2</sup> says “*the expensive seeds of new knowledge often fall on infertile soil*”. The time of knowledge does not allow improvisation. Using scientific achievements through practicing them instead of just being satisfied with barely owning them shifts the paradigm established in the past. A change of habits, views, and way of functioning is what everyone must do in order to adapt to the new times.

## 1. Theoretical approaches to knowledge management

Knowledge is an organised combination of ideas, rules, procedures, and information. Only through “the organisation” does the information attain life and become knowledge. Quinn<sup>3</sup> equates knowledge with professional intellect. According to this view, organisational knowledge is a metaphor at best, because knowledge is created by the people in the organisation, not the organisation itself. Nonaka<sup>4</sup> defines knowledge as a justified belief, where beliefs are used to justify self-interests. This concept is compatible with the so called ‘constructor’s perspective’. In the context of the abovementioned perspective, the actors determine and construct truths based on their

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<sup>1</sup> Bergeron, B., *Essentials of Knowledge Management*, John Wiley and Sons, New Jersey, 2003, p. 12.

<sup>2</sup> Senge, Peter, *The Fifth Discipline, The Art & Practice of the Learning Organization*, Doubleday Currency, 1990, p. 32.

<sup>3</sup> Frappaolo, C., *Knowledge management*, Capstone Publishing, Oxford, 2002, p. 21.

<sup>4</sup> Nonaka, I., *The Knowledge creating company*, Harvard Business Review, 1991, p. 14.

mental models, which, on the other hand, are shaped through interpretation and communication with others. In this way, part of the knowledge becomes public good, which is being continuously reassessed and reinterpreted by other members of society. The other part of the knowledge remains exclusively in the individual's domain. This knowledge will not be furthered – it is unique and it will remain with the individual, regardless of the way of (non)disposal.

Knowledge management is a process of facilitating the knowledge-related activities, such as creativity, transformation, and use of knowledge. This managing process includes a line of activities – from learning, collaboration, and experimenting, to integrating various sets of tasks and implementing powerful information systems (internet, intranet, and extranet). An organisation ought to possess an adaptable and flexible organisational structure in order to efficiently manage knowledge.

Knowledge management is a new interdisciplinary concept for a manner of work, which holds organisational knowledge in its focus. It is rooted into many disciplines including economy, psychology, information systems management etc. Knowledge management includes human resources, technology, and processes as interconnected and the parts which do not fit. Every definition for knowledge management contains several integral parts<sup>5</sup>:

- Using knowledge from external sources;
- Implementing and cultivating knowledge in the work processes, products, and services;
- Presenting knowledge in databases and documents;
- Promoting the growth in knowledge through the organisational culture and motivating the employees;
- Transfer and use of knowledge throughout the whole organisation;
- Estimate of the benefit from the application of knowledge and its implementation in the organisation's basis.

Knowledge management is a process of adopting and using the collective experience of the organisation in any work process – via paper, documents, database (explicit or visible knowledge) or in the minds of the employees (implicit, invisible knowledge). The research so far<sup>6</sup> has

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<sup>5</sup> <http://www.kmnetwork.com/whatis.htm>

<sup>6</sup> *Ibid.*, p. 44

shown that 95% of knowledge is in fact hidden or implicit knowledge, which is the impetus for innovation – the only competitive advantage allowing the organisation a possibility of survival in the unpredictable market environment. The worth of a modern organisation lies in the power to perceive all processes as ones of knowledge. This includes creating, spreading, upgrading, and applying knowledge in the entire organisation. Modern organisations demand opportunities for creating an added worth through identifying, applying, and using knowledge in a special, unique manner, which is a cohesion of science, art, and also luck. That is the concept of collective knowledge, whose final objective is more efficient application of knowledge in the decision-making process. The value of the knowledge management concept is “an ability to reach information in a short time which will enable the employees to make the best decision, regardless whether it is about the market conditions, products, service, processes, planned activities of the competition, or other information important for the organisation’s success”<sup>7</sup>.

## **2. Knowledge management traditions in the Republic of Macedonia**

Starting from the premises listed above, that the successful knowledge management programmes are a significant factor for gaining and maintaining competitive advantage in terms of global competition and a changeable business environment, their existence and implementation in the domestic practices is exceptionally significant for Macedonia’s development. Therefore, a research has been conducted, where the connection between knowledge management and information technologies, organisational culture, and management style is tested, as factors which directly influence the successfulness and effectiveness of knowledge management in Macedonian companies, with the competitiveness of Macedonian economy.

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<sup>7</sup> Masic, B., Knowledge Management: Kreiranje konkurentne prednosti u novoj ekonomiji, Strategijski menadžment, br.1-2/2003, str. 57.

## 2.1. Methodology and characteristics of the research sample

The research, in the form of surveys and interviews, was conducted in the period between November 2011 and January 2012 and it included 68 participants from different profiles in the Macedonian companies, such as top management, middle management and operative management. Moreover, it was conducted upon a relevant sample of companies that appropriately reflect the organisational, ownership, and sector structure of domestic economy. When constituting the sample, gender equality (as a relatively new development concept) has been taken into account, hence 54.4% of the total participants surveyed were of the male gender, and 45.6% were of female gender. Furthermore, special attention was also paid to age and educational structure of the participants. 44.1% were participants aged between 41 and 50 years, educated and brought up in a different, systematic, and socialist economic system. This choice was made because the contemporary global practices have shown that the pillars of reform in a modern society, if we take into account knowledge and professional experience gained, are exactly these generations.

The fact that Macedonia has an educated population was also confirmed by the educational structure of the participants in the research. The largest part of the research was conducted upon participants who had completed undergraduate studies – 66.2%, 11.8% had completed post-graduate studies, and 5.9% held a PhD. Only 10.3% of the total number of participants had finished only secondary education. The choice of the field of work structure is presented in Figure 1, from which one can clearly see that industry is prevalent among the other fields of work.

**Figure 1. Structure of the companies included in the sample according to their field of work**



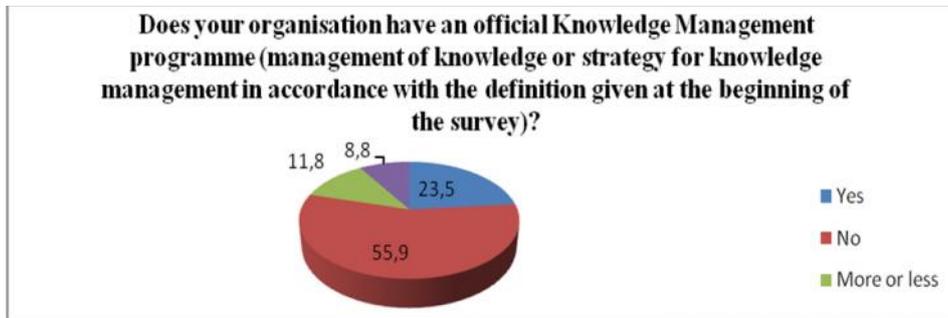
Furthermore, a distinction was made between old privatised companies and newly founded companies, and in the sample, as many as 76.5% of the participants answered that their organisation did not go through the privatisation process in the last three years.

## **2.2. Research results**

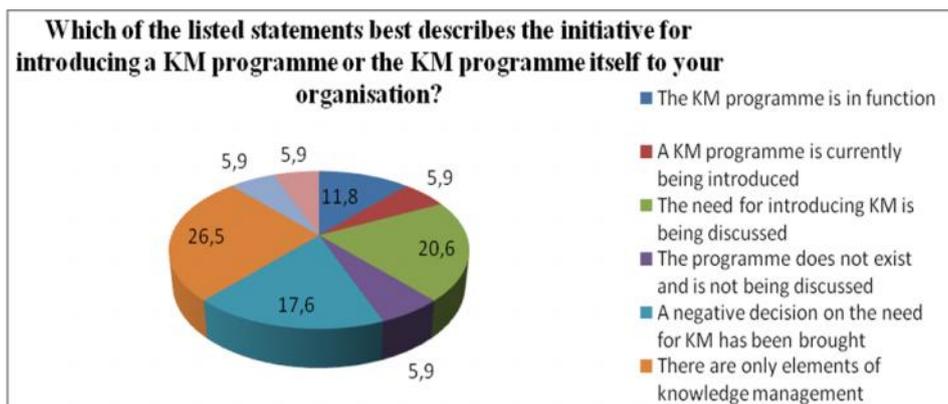
Taking into account the fact that the successes of a company and its competitive sustainability in the new economy are based upon knowledge, which, amongst other things, is gained by unhindered and unselfish exchange of information, the question “Do the organisations recognise the key resource in the economy (which is knowledge)?” received an affirmative answer from as many as 66.2% of the participants. 16.2% answered with “More or less”, and 11.8% with “No”. These answers clearly show that the circumstances in Macedonia, slowly but surely, are changing towards recognising the new competitive society, which is a clear EU mission, as well as the mission of the Republic of Macedonia to enter NATO and EU as soon as possible.

The recognition of the new concept does not directly mean that the practice is such as well, that is to say that the concept is used in the work. Namely, through the analysis of the results of the research (Figure 2, 3, 4, 5 and 6) - the existence and initiative for programmes for knowledge management, distribution, sources and lost knowledge in the companies, it can be established that knowledge management, as a new domain, is still underdeveloped in Macedonian organisations, except for utilising IT technologies as its source (Figure 7), but it does significantly attract the managers’ attention. Another interesting fact is that the need for knowledge management is felt in the private sector (as it was expected), but in the public sector as well (meaning one can anticipate changes in management with processes in this sector as well).

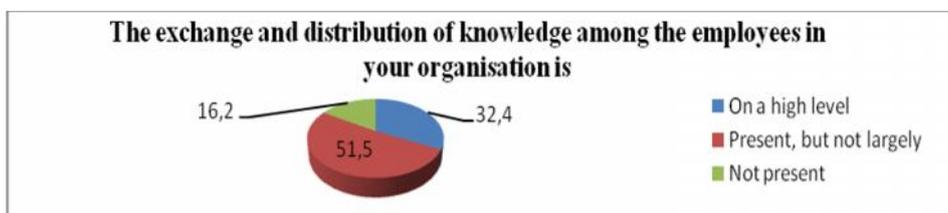
**Figure 2. Possessing programmes/strategies for knowledge management in Macedonian companies**



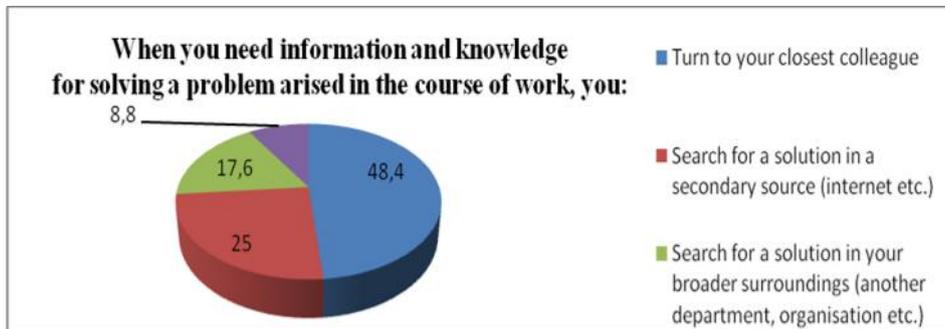
**Figure 3. Statements related to initiative for introducing Knowledge Management in Macedonian companies**



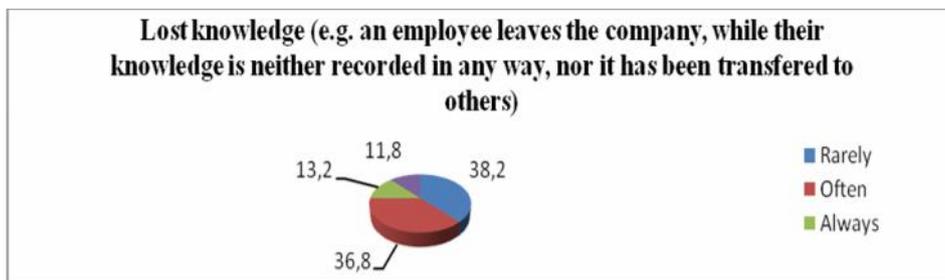
**Figure 4. Distributing the knowledge among employees in the Macedonian companies**



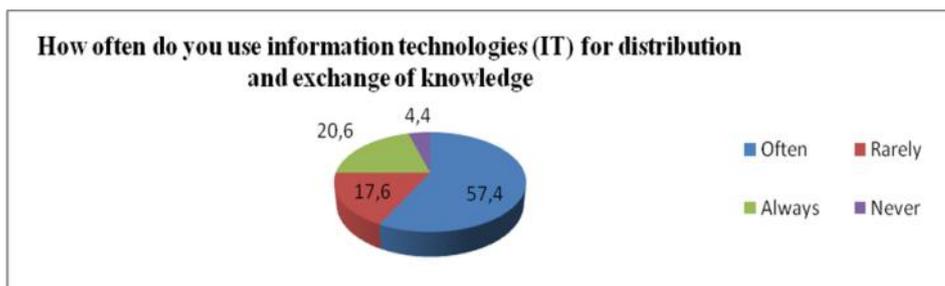
**Figure 5. Knowledge sources**



**Figure 6. Lost knowledge**

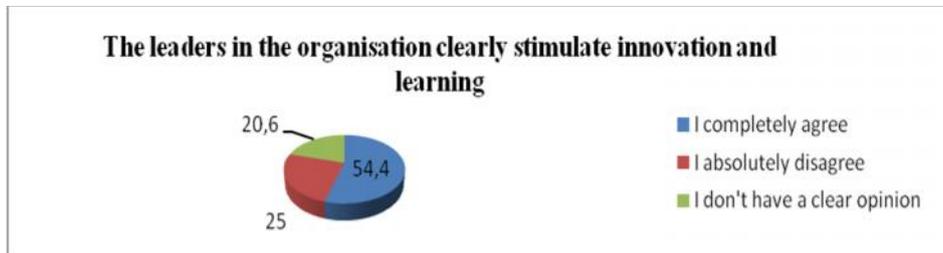


**Figure 7. Using IT in knowledge**



The research has shown that in Macedonia, the awareness for application of the knowledge management programme can be soon expected to increase in the organisations, which will contribute to increasing the competitiveness of the organisations and their sustainability in the country and beyond.

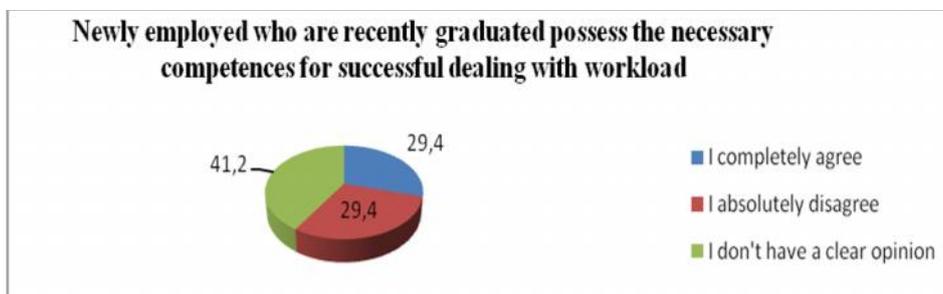
**Figure 8. The company leaders' behaviour in relation to knowledge**



Moreover, it can be concluded that the participants in the research assessed their leaders as persons who regard knowledge as a main company asset, who launch initiative and support for the processes of creation, distribution and application of knowledge, who have a clear vision how to use knowledge and create a greater added value through using clear, open, efficient, and effective communication. It is exceptionally significant that many of the participants (44.1%), who have been educated and brought up in another, systematic, socialist economic system, declared that they can successfully keep up with new challenges.

Taking the theoretical knowledge into account, the main accent in the research was put on the competences which the newly employed must possess and on the developed career centres and centres for academic specialisation in all strata of society, for instance, professional orientation in primary and secondary school and the successful development of all affinities, skills and abilities in the course of university studies, all of which are necessary for a successful professional realisation of individuals. As expected, the results have confirmed (Figure 9) that this is a big handicap for almost all organisations, and a lot of attention must be dedicated to it in the future, both on a micro and macro scale.

**Figure 9. Competence of newly employed necessary**



## **Conclusion**

In Macedonia, the key factors for recognising and implementing the knowledge management process are the organisational culture and the operation style of the managers - factors which still have not received the necessary attention in the two-decade long process of transition towards a market economy. The research conducted has shown that people are not acquainted enough with the concept, that some of its elements are intuitively applied and that the awareness that it is needed is increasing. Therefore, despite our tradition, it is necessary to take steps for realising a competitive advantage in the changeable business environment and for meeting challenges, such as:

- Instigating personal development, innovation and creativity;
- Having a clear vision of the organisation's movement by building clear strategic plans;
- Creative and free expression of the employees;
- Valuing the immaterial assets of the organisation;
- Nurturing teamwork, encouraging innovativeness;
- Motivating the sharing of knowledge;
- Sense of belonging to the organisation;
- Participation in the decision-making processes, permanent and constant learning and specialising;
- Upgrading the system for distributing knowledge;
- Adequate business environment;
- Developing the knowledge in the organisation, collaboration, availability of knowledge;
- Developed communication channels and a developed technological infrastructure.

In this context, a positive factor is the traditionally good educational structure of the Macedonian population, which later should be modelled into gaining necessary competencies through a process of quality trainings and specialising in education on all levels. What remains is the challenge of reforming education for the sake of successful development of the professional affinities, skills and abilities of the labour force, that is to say, a quality supply to the demand of the labour market in Macedonia.

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**Original scientific paper**

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## **THE AFFECTIVE AND COGNITIVE COMPONENTS AS FACTORS IN COUNTRY BRANDING**

### **Abstract**

The idea of the power of image or authority as a way to achieve political, social, economic and cultural goals, dates as back as the country itself. The need for a thorough study of these aspects in our time is greater than ever.

All governments on behalf of their peoples, institutions and companies must have a view of the world's perception of their country and develop a suitable management strategy. The main emphasis in this process should be on how to create a brand which will be truthful, authentic, powerful, attractive, and useful for achieving their economic, political, and social aims.<sup>1</sup> In the same time, it must be a true representation of the people's spirit, originality, ingenuity, and will. The governments of the 21<sup>st</sup> century faced with this great task must also make it their primary one.<sup>2</sup> Country brand and branding as new tendencies in marketing are the result of the expanding globalization as well as the needs of a country striving for sustainable economic development.

This paper defines brand and country branding from a marketing point of view, and moves on to discuss factors relevant in brand building. The effective combination of these factors in country branding from a

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<sup>1</sup>According to Simon Anholt, one of the most renowned theoreticians, an expert on managing nation identity and image:

<http://nation-branding.info/2010/01/01/13/sout-korea-upadate-country-nation-branding-seriously/>

<sup>2</sup> Skoko, Božo. *Država kao brend*. Zagreb: *Matica Hrvatske*, 2009, p. 10.

marketing point of view is portrayed with two successful examples: Iceland and Chile. These examples can serve as guidance in branding other countries, including the Republic of Macedonia.

**Key words:** brand, country branding, principles of branding, affective factors, cognitive factors.

**JEL classification:** M3; M38; M39

### **Introduction**

Significant changes in the socio-economic and political structure of the modern society happened in the last few decades. Fast development and increasing media impact, global public opinion as well as global economic relations all reflected in the behavior of consumers in the decision-making process. It also affected how political and economic institutions functioned, and as a result, the image gained “power”.<sup>3</sup>

The power of a country’s image is not a modern acquisition. On the contrary, during the last 500 years, each century was marked by the power and role of one superpower. In the 18<sup>th</sup> century this was Spain, in the 17<sup>th</sup> century France, in the 19<sup>th</sup> century England, and the 20<sup>th</sup> century belonged to the USA. Although each of these countries knew how to manage its power and strengths, the way they earned this image differs and was in tune with the epoch.

The rapid progress of globalization in the 21<sup>st</sup> century pushed each country, city or region in a race for a piece of the global cake. As a consequence, the countries had to find ways to become competitive on the global market and have a clearly defined, genuine appeal as well as a specific and well-planned vision, identity, and strategy.

The era when the image of a country was based on its military, political, and economic power is in the past. In the new millennium a country can be competitive only if it is recognizable; it owes its recognition to its natural resources, the set of values of its citizens, its products, cultural, historic or spiritual values, or a combination of the above. Besides the fact that this paper deals with a global theme, the main goal is to stress the importance of the affective and cognitive

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<sup>3</sup> [http://earthSpeak.com/Why\\_is\\_branding\\_so\\_important.htm](http://earthSpeak.com/Why_is_branding_so_important.htm), 5<sup>th</sup> March, 2007.

components as the starting point in the process of branding. In this respect, the paper gives an account of the brand building in Iceland and Chile on the basis of cognitive components.

## 1. Definition of Brand and Branding

The theory of economics gives several definitions concerning the brand. According to the American Marketing Association (AMA)<sup>4</sup>, a brand is a name, term, design, symbol, or any other feature that identifies one seller's good or service as distinct from those of other sellers. According to a different view<sup>5</sup>, the brand is defined as the personal experience of a product, service or a company. Kotler's definition<sup>6</sup> of brand states that a brand is a name, symbol or design which identifies the producer, whereas the product can be any material good, service, organization, place, subject or idea. Based on these definitions, one could conclude that the brand identifies a product and it allows for easy selection, pinpointing, and recognition of a product.

Speaking in terms of countries, a group of authors define brand as a combination of a nation's elements which refers to the cultural and historic values. These values are utilized when the nation's distinctiveness and relevance for the target group are created.<sup>7</sup> Another group of authors<sup>8</sup> maintains that a brand is the same with the nation; a nation embraces the past and prepares for future challenges, therefore, according to this group, the nation isn't eternal – as it came to life, it will also come to an end.

Simon Anholt's definition<sup>9</sup> of brand talks of the way a country is perceived by its own citizens in the first place, and by those of other countries in the second place. According to him, if a brand is defined through the way an organization communicates and differs from the other, then the country-brand or the national brand does the same with the whole country.

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<sup>4</sup> Kotler, Philip; Gerther, David. *Country as a brand, product and beyond a place marketing and brand management prospective destination branding* (second edition). Oxford: Ebsvier Butterworth Heinemann, p. 46.

<sup>5</sup> Premovi, Miljan; Damjanovi, Vesna. *Strateški pristup brendiranje nacije*, Beograd: Menadžment marketing i trgovina; 2009 god; p. 201.

<sup>6</sup> Philip, Kotler; Nancy, Lee. *Marketing u javnom sektoru*. Zagreb: Mate, d.o.o., 2007, p. 114-115.

<sup>7</sup> Premovi, Miljan; Damjanovi, Vesna. *Strateški pristup brendiranje nacije*, op. cit., p. 202.

<sup>8</sup> Kotler, P. i Keller, K. *Marketing menadžment*. Beograd: Data Status, 2006.

<sup>9</sup> [http://www.sourcewatch.org/index.php?title=Nation\\_branding](http://www.sourcewatch.org/index.php?title=Nation_branding)

Branding is different from brand; branding as a process is discussed by Kotler and Keler<sup>10</sup> as applicable in all areas which offer the consumer the right to choose. In essence, branding is a term that covers several aspects: name, design, symbol, copyright elements that protect a product's identity, service, and manufacturer.<sup>11</sup> The analysis of various definitions of branding shows that branding is a mix of art and science, used to manipulate the associations between brands and the memory of the target group.<sup>12</sup>

Based on the above, it is obvious that the country-brand is more than just a mere image or perception. It is an emotional relationship with a target group that provides wide recognition and a place on the global scene.<sup>13</sup>

## **2. Cognitive and Affective Components as Factors in Country Branding**

Branding a country is a process of designing, planning, and communicating the name and identity, with the aim of creating and managing the brand. When a country is branded on the basis of its national identity, it should be noted that there is no common way to construct a national identity based on the same set of factors. There are many countries around the world that cannot build their national identity and image based on their economic, political, and military power as they do not have any. But, at the same time, their rich historic, cultural, and spiritual heritage enables them to be recognizable, and to build their identity and image on these foundations.

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<sup>10</sup> Ibidem.

<sup>11</sup> Arsov, Danco. *Marketing-aspekti vo procesot na brendiranje i gradenje brend na gradovi na primerot na grad Skopje* (masters dissertation). Skopje: *Ekonomski institut Skopje*, 2010, p. 15.

<sup>12</sup> Ibidem.

<sup>13</sup> Anholt, Simon. *Competitive identity, The New Brand Management for Nations, Cites and Regions*, New York; Palgrave Macmillan, 2007, p. 4.

## 2.1 Affective and Cognitive Factors

The term “affective” is derived from the term “affection” which refers to the strong inner emotional experience of humans.<sup>14</sup> The affective factors include those factors that affect the perception of a particular value as higher than it actually is, due to subjective reasons (strong inner emotion). The paper studies affective factors as referring to: culture and cultural heritage, folk wisdom and level of spirituality with the emphasis on the subjective element, as well as the inner feeling or experience triggered by cultural values, wisdom, and spirituality of the country’s residents.

The term cognitive or conscious refers to any mental operation or structure. Cognition is the greatest exercise of the intellect founded on human experience and reasoning.<sup>15</sup> Based on the terminology and definition of the word “cognitive”, this work treats cognitive factors as referring to nature’s treasures and historic heritage of a country. This group of factors stresses objective elements (nature’s treasures and historic heritage that have existed or still exist).

The affective and cognitive factors have two completely opposite characteristics. Firstly, the ability to establish propositions (creating ideology), an outward action, and secondly, the ability to persuade (to convince or advise)<sup>16</sup>, which is an inward action.

### 2.1.1 The Role of Affective and Cognitive Factors in Branding

Culture and cultural heritage, folk wisdom, and the level of spirituality as affective factors are aspects that can lead to powerful emotional experience which could be used as the foundation of a country’s identity and brand. The example of some countries with rich culture and cultural heritage shows that such feelings are present both in the residents and nonresidents of the country. For instance, Italy with its rich cultural and historic heritage is a good example of a country that uses such assets to boost its brand and identity.

The wisdom and spirituality of people are nonmaterial factors that may induce strong emotional experience and connection. For instance, in the orthodox Christian world, the spiritual component is most visible

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<sup>14</sup> Filipovi , Marjan. *Rje nik stranih rije i*. Zagreb: *Zadružna štampa*, 1988: p. 14.

<sup>15</sup> *Ibid.* p. 188.

<sup>16</sup> *Ibid.* p. 275.

upon mentioning Constantinople<sup>17</sup> (present day Istanbul), the capital of the Empire which ceased to exist almost four centuries ago, and yet maintains its role as a spiritual center. Likewise, Mount Athos<sup>18</sup> is a spiritual symbol in the orthodox world and has made the Khalkidhiki peninsula (where it is located) an attractive destination for many visitors.

While affective factors are marked by subjectivity or irrational perception, cognitive factors affect the rational perception. The influence of these factors is best seen in the potential to create a myth or an ideology about the country's eternal and inevitable character.

Thus, branding a country based on these factors<sup>19</sup> is done by acknowledging its attractions, natural beauties and their surroundings, and the values set by its historic heritage. Building an image or a brand based on these factors does not depend on the information gathered by the individual from various sources only, but, most of all, on the characteristics of these factors.

The cognitive or perceptive aspect of country branding is visible in the characteristics of the country, such as its nature's treasures, clean environment, and historic heritage in the form of events, people or buildings. A good example of the influence of cognitive factors is the branding of Dubrovnik as a tourist destination by employing a set of cognitive factors.<sup>20</sup>

The economic theory reveals certain ambiguity between theoreticians regarding the meaning and influence on the affective and cognitive factors in brand building and their advantages and disadvantages. Accordingly, some theoreticians maintain that the brand of a country cannot be constructed solely on the basis of cognitive and affective factors, but these can be used as extras. The brand should be founded on the economic, political, and military power of the country.

It is a fact that the economic, political, and military power of a country play a role in the brand building, however, it is disputable

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<sup>17</sup> Constantinople – the capital of the East Roman Empire, a byzantine civilization that existed from 330-1450 when it was conquered by the Turks.

<sup>18</sup> According to the Orthodox Tradition, the Mother of God was sailing accompanied by St John the Evangelist on her way to Cyprus. When the ship was blown out of course to then pagan Athos it was forced to drop anchor. The Virgin walked ashore and, overwhelmed by the wonderful and wild natural beauty of the mountain she blessed it and asked her Son for it to be her garden. A voice was heard; "let this place be your inheritance and your garden, a paradise and a haven of salvation for those seeking to be saved". Since that moment the mountain was consecrated as the garden of the Mother of God.

<sup>19</sup> Kesi , Tanja. *Country image and product brand iamge as a competitive marketing strategy factors*. Zagreb: Faculty of Economics and Business, University of Zagreb, 2009, p. 6.

<sup>20</sup> Ibidem.

whether they are the only factors a country should use when shaping its distinctiveness. Branding a country using affective and cognitive factors provides opportunity for detecting, identifying, and defining its particular characteristics and benefits. These will be used to create a recognizable image which will provide the country with a more competitive place on the global market.

The weakness of this idea the poor familiarity and understanding of the potential and influence of the affective and cognitive factors in country branding. The downside of this idea is the fact that it is not easily put into practice. When discussing the obstacles, one should be aware of the following<sup>21</sup>:

- a) A large part of the world doesn't have a postindustrial society which limits the transformation of power;
- b) Africa and the Near East are in the stage of pre-industrial society with insufficiently developed institutions;
- c) Countries such as China, India, and Brazil are industrial economies analogue to some western ones.

Therefore, building a country's brand based on the cognitive and affective factors is an opportunity for countries with small economies and developing countries to build a brand and recognizable image based on their singularities and benefits. The affective and cognitive factors are important for countries whose brand is mainly founded on the economic, political or military power as they can additionally contribute to the brand management.

### **3. Cognitive Components as Factors in Branding a Country – Iceland and Chile**

#### **3.1 Iceland**

In general, the strategy behind Iceland's brand is founded on cognitive factors, the nature and its resources as well as the people's culture of living.

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<sup>21</sup> Kesi , Tanja. *Country image and product brand image as a competitive marketing strategy factors*, op. cit., p.7.

Iceland's example illustrates the importance of both the basis for branding and the wrong perception Icelandic people had about themselves before the branding had started. Namely, according to a research about the rating of the nation among the Scandinavian countries and the OECD member countries which was conducted by Anholt in 2007<sup>22</sup>, out of 37 countries, Iceland was the 19<sup>th</sup> in popularity ranking.

These results "enlightened" the Icelandic authorities as they realized that the perfect image about their countries was in their imagination only. Subsequently, the Icelandic government started looking into the current state of affairs with respect of the country's image and possible ways to find a solution. Therefore, they appointed Anholt to conduct a research and to prepare a project to brand Iceland that would found the Icelandic brand in "clarifying certain aspects of the image of its people, i.e. nation".<sup>23</sup>

Anholt elaborates on its branding strategy claiming that when potential investors are about to decide whether to invest, their decision is not based solely on the economic factors. Rather, it is a predominantly emotional decision and it is determined by their perception and impression of the nation's image and reputation.

Because of this, Anholt suggested to the Icelandic authorities first to decide what investments should enter the country, and then the aspect of its image will be accordingly clarified. This was expected to influence the decision-making of future investors. Hence, according to Anholt, if Iceland decides to favor high-tech companies, then the aspect of the country's image regarding its relevant education and expertise will have to be clarified.

For this reason, the motto of the strategy for Iceland's branding was "The image should be of a trophy-wife and not a street-hooker"<sup>24</sup>, while the basis for branding was made up of three nuclei: energy, freedom, and peace, applied in four important fields: nature, people, business, and culture.

This strategy was developed based on previously obtained results concerning the country's existing image in coordination with the vision for the future of Iceland, based on actual potential. So, according to the creator of this strategy<sup>25</sup>:

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<sup>22</sup> <http://nation-branding.info/2009/04/01/branding-iceland/>

<sup>23</sup> Ibidem.

<sup>24</sup> <http://nation-branding.info/2009/03/25/brand-chile-10-point-action-plan-unveiled/>

<sup>25</sup> Ibidem.

- **Energy** is reflected on nature, since Iceland's nature is rich in green energy which can produce renewable energy. It connects with people who are ready and determined, and reflects on business and culture, since the Icelandic people are creative and productive.
- **Freedom** relates with nature by means of free and clean space. It is crucial to people since they are independent and business is not smothered in bureaucracy and corruption. It relates with culture too, as free minds create clean art.
- **Peace** has to do with preserving the environment which reflects on people as they create a safe society. The safe society is closely connected to business, culture, peace, and love of the Icelandic people.

Apart from the image it provides on how to create a brand of a country based on cognitive factors, Iceland's example sheds light on two important issues for any country that wants to start the process of branding:

1. A country's image does not reflect the original idea. It is not the fruit of some irrational perception or a reflection of the collective egoism. A country's image should be set on realistic unbiased research, as this is the only way to find out what exactly is needed for it to be improved.
2. The basis of branding must not be traced solely in our desire, i.e. what image we wish for our country, but in what we really are, what we can offer and accomplish, and what sets us apart from the rest.

Iceland's example shows that there is a real need to conduct marketing research when branding a country, especially when establishing the current image of the country and the foundation for brand building.

### **3.2 Chile**

Having assessed the importance and benefits of creating a recognizable image of the country, Chile's authorities set off with the brand building strategy by hiring the world-wide renowned authority in marketing, Simon Anholt.

The results from the research that was conducted so as to get a truthful idea of the current image of Chile before the branding starts showed that Chile is one of the many countries that have neither positive nor a negative image, rather a "weak" image.

It was an anonymous and uncompetitive country with over 200 companies on the market. Anholt used the results of the research as basis for acquainting the Chilean public with the significance of their country's image.

Chile's branding campaign was run with the motto: "As long as we are respected, we are rich. If we lose the respect, we grow poor." Anholt was inspired to use this motto from William Shakespeare's Othello<sup>26</sup>, especially from Iago's words addressed to Othello:

*"Good name in man and woman, dear my lord,  
Is the immediate jewel of their souls:  
Who steals my purse steals trash; 'tis something, nothing;  
'Twas mine, 'tis his, and has been slave to thousands:  
But he that filches from me my good name  
Robs me of that which not enriches him  
And makes me poor indeed."*

When developing Chile's branding strategy, Anholt used the results from the research according to which Chileans, unlike other people, have a strong feeling of national identity and this was considered an asset. The strong sense of national identity was the main reason behind the campaign's motto: "Chile is the best country in the region", whose purpose was to improve Chile's image.

When Anholt chose the strategy and the basis for Chile's brand, he was aware of the country's weak economic, military and political power, and that is why he opted for the cognitive factors, or Chile's nature and historic heritage.

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<sup>26</sup> <http://shakespeare.mit.edu/othello/full.html>

During the campaign, all participants were continuously instructed that the country should be presented as it is, not as they wish it to be. For this purpose, apart from the campaign's motto, the branding was marked by another slogan inspired by Socrates: "The way to a good reputation is to endeavor to be what you desire to appear." It is actually a rather risky statement, since one should not worry about one's reputation – it is superficial. One should think about reality because better reality earns better reputation. Reputation (or image) is the reflection of reality.<sup>27</sup>

### **Conclusion**

The advantages of a positive image and perception of a country by other developed countries have been long known and acknowledged. Many countries made an export story out of their way of life and set of values and won the global market. In the past few years we are witnessing many countries that start paying a lot of attention to their image. As a result, the positive image is no longer a privilege of the countries with economic, military, and political power.

Consequently, the brand of a country is now understood primarily as the way citizens perceive their country, and later those of other countries. A country's brand is a condition for its global success and development. For this reason, branding is an important process that takes years to the benefit of all.

Since image cannot be "created" but "earned", countries started selecting the elements for their branding very carefully. Thus, most countries present themselves to the international public in the light that makes them look most productive, starting from culture, art, customs, and lifestyle.

The national identity as the base for country brand building is a subject to change; it is not limited to the country's economic, military and political power. In the 21<sup>st</sup> century, the national identity is a mix of economic, military, political, ethnic, environmental, cultural, historic, and spiritual components.

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<sup>27</sup> Ibidem.

This understanding of national identity allows many countries without economic, military or political power to create a brand and image based on the affective and cognitive factors. Iceland and Chile are examples that clearly demonstrate the influence of the cognitive or perceptive aspect of nation branding visible in the national symbols, energy, freedom, and peace articulated through the country's nature and green environment.

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Original scientific paper**

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**LIFELONG LEARNING FOR BEST ADAPTATION TO THE  
21.CENTURY CHANGES IN THE WORLD OF WORK**

**Abstract**

Since the lifelong learning has been recognized as a high priority need for the individual, organization and society and many different learning methods, techniques and activities are constantly being created and applied in order to build and develop the necessary knowledge, skills and competences, the question that arises is: what kind of lifelong learning is most adequate for best adaptation to the 21.century rapid changes in the world of work? Or more specific: what do people think and/or expect from the lifelong learning, so it can be considered effective and most appropriate? So for that purpose, this paper shares the findings from a research conducted on postgraduate students on Human Resources Management in the frames of the Institute for Sociological, Political and Juridical Research as a formal type of education and part of the lifelong learning process in the field of organizational/business studies.

**Key words:** lifelong learning; skills and competences; 21.century changes; world of work.

**JEL classification number:** 125 , Education and economic development

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## 1. Introduction

The world of work in 21 century is in a constant state of flux and change. Technological development is introducing new skills and making others redundant; the high rate of unemployment is demanding new training and retraining; the shift from rural to urban employment requires a change in competencies and life style; migration and the displacement of people around the globe need a reorientation to a different sphere of the world of work: all these, and other factors, demand commitment to and provision for life-long learning. The world of work requires it's participants to have the opportunity for constant personal and professional development. However, life-long learning requires personal commitment and motivation that will only develop when such learning is rewarded. Further, all our efforts to make continuing education a reality in our societies will fail unless people develop the attitudes and values that encourage them to make the commitments necessary to engage in this area of education.

The world of work is experiencing major changes in patterns of production as well as dramatic innovations in technologies in the context of a more competitive global economy. There are major shortages of qualified workers for new industries, the displacement of labour, dislocation of people, reduced unionization, unemployment, obsolescence of skills and production techniques, gender inequalities and precarious employment. An increasing proportion of the working population exists outside the range of mainstream labour market policies, and formal education is able to meet the demands of only a very small proportion of this population. All these changes confront us day after day and reinforce the tremendous importance of lifelong learning as well as explain the growing demand for adult and continuing learning. Acknowledging the changing nature of work and the effects of policies to increase productivity, which result in considerable loss of jobs, we must affirm the importance of the right to work, as well as the role of adult learning which needs to be seen as an investment for better future.

The contemporary concept of the Lifelong learning, as it is defined by the European Commission documents, primary with the Lisbon strategy (March, 2000) understands "*all learning activities undertaken throughout life, with the aim of improving knowledge, skills and competences within a personal, civic, social and/or employment-*

*related perspective*". The breadth of this definition also draws attention to the full range of:

- formal
- non formal and
- informal learning activities.

The main idea is that, besides the knowledge, everyone has to gain, improve and development eight key competences, according to the European Reference Framework, to be able to cope with the 21. century changes, job tasks, and everyday life responsibilities in all spheres. The key competences for LLL are:

- Communication in the mother tongue
- Communication in a foreign language
- Mathematical literacy and basic competences in science and technology
- Digital competence
- Learning to learn
- Interpersonal and civic competences
- Entrepreneurship
- Cultural expression

There is also, European Qualification Frame of Lifelong learning, with qualifications at 8 referent levels, established with recommendations by ILO.

Actually, the Lifelong learning in its practice should be the best solution for:

- Personal fulfillment and development throughout the life (cultural capital): key competences must enable people to pursue individual objectives in life, driven by personal interests, aspirations and the desire to continue learning throughout life;
- Active citizenship and social inclusion (social capital): key competences should allow everybody to participate as an active citizen in society; and
- Employability/adaptability (human capital): the capacity of each and every person to obtain a decent job in the labour market.

The main priorities for action are: investing/financing in human resource development, corporative social responsibility, bringing closer the learning to the learner, making the education more attractive;

organizational learning; equal educational opportunities for everyone, valorization, certification etc.

This paper makes an effort to investigate the preferences of people for lifelong learning model in order to cope with the changes in the world of work.

## **2. Methodology**

For this research paper primary source of quantitative data was used, which was collected by questionnaire. The collected data was analyzed through descriptive statistics, at univariate and bivariate level. The first level was analyzed and illustrated by frequencies, mean values and standard deviation. And for the second level there were used cross tabs. The collected data was analyzed with the SPSS (Statistical Package for Social Science) and the results are presented by tables, with interpretation and discussion by the authors.

The sample for this research was purposive, consisted of 73 respondents and the criteria for its design was: (a) active students at postgraduate studies (b) in Human Resource Management (c) at the Institute for Sociological, Political and Juridical Research in Skopje. This sample is considered adequate for the research subject as the respondents represent a category of people which have chosen to continue with their formal education in the field of organizational/business studies so they could use their new gained knowledge and qualifications in the world of work.

## **3. Results and discussion**

Initially the respondents were asked: *How well do you cope with the 21st century changes?* In the following three tables we can find the results made by a cross tabulation by three variables: sex, age and working status. The results tell us that there is a significant difference between male and female respondents' answers and the conclusion is that sex as a variable plays an important role on the way of coping with the changes, i.e. women consider that they better cope with the changes. The age is also an important variable, as there are great differences between the results, but a more precise analyze cannot be done, as the respondents from the third age-category are statistically not representative.

Toward the working status as a variable, it brings conclusion that people who work more difficult cope with the changes, than people that don't work. The 27,7% of total amount of respondents answered that they cannot cope in society, 23,3% at work, 20,5% in social relations, and 5,5% in family.

**Table 1. Coping with the changes/cross tabs by sex**

Sex \* How well do you cope with the 21.century changes? Crosstabulation

			How well do you cope with the 21.century changes?					Total
			very good	good	average	bad	very bad	
Sex	male	Count	12	5		6	6	29
		% within Sex	41,4%	17,2%		20,7%	20,7%	100,0%
		% of Total	16,4%	6,8%		8,2%	8,2%	39,7%
	female	Count	16	18	8		2	44
		% within Sex	36,4%	40,9%	18,2%		4,5%	100,0%
		% of Total	21,9%	24,7%	11,0%		2,7%	60,3%
Total	Count	28	23	8	6	8	73	
	% within Sex	38,4%	31,5%	11,0%	8,2%	11,0%	100,0%	
	% of Total	38,4%	31,5%	11,0%	8,2%	11,0%	100,0%	

**Table 2. Coping with the changes/cross tabs by age**

Age \* How well do you cope with the 21.century changes? Crosstabulation

			How well do you cope with the 21.century changes?					Total
			very good	good	average	bad	very bad	
Age	20-35	Count	19	21	3	3	8	54
		% within Age	35,2%	38,9%	5,6%	5,6%	14,8%	100,0%
		% of Total	26,0%	28,8%	4,1%	4,1%	11,0%	74,0%
	36-45	Count	9	2	5			16
		% within Age	56,3%	12,5%	31,3%			100,0%
		% of Total	12,3%	2,7%	6,8%			21,9%
	46-55	Count				3		3
		% within Age				100,0%		100,0%
		% of Total				4,1%		4,1%
Total	Count	28	23	8	6	8	73	
	% within Age	38,4%	31,5%	11,0%	8,2%	11,0%	100,0%	
	% of Total	38,4%	31,5%	11,0%	8,2%	11,0%	100,0%	

**Table 3. Coping with the changes/cross tabs by working status**

**Working status \* How well do you cope with the 21.century changes? Crosstabulation**

			How well do you cope with the 21.century changes?					Total
			very good	good	average	bad	very bad	
Working status	employed	Count	19	13	5	6	6	49
		% within Working status	38,8%	26,5%	10,2%	12,2%	12,2%	100,0%
		% of Total	26,0%	17,8%	6,8%	8,2%	8,2%	67,1%
	not employed	Count	9	10	3		2	24
		% within Working status	37,5%	41,7%	12,5%		8,3%	100,0%
		% of Total	12,3%	13,7%	4,1%		2,7%	32,9%
Total	Count	28	23	8	6	8	73	
	% within Working status	38,4%	31,5%	11,0%	8,2%	11,0%	100,0%	
	% of Total	38,4%	31,5%	11,0%	8,2%	11,0%	100,0%	

On the question: *Do you think that your last completed formal education gave you the required knowledge/skills for your employment/job?* respondents' answers show the mean of 2.84 (1 - very much; 5 - not at all), which says that the last formal education maybe wasn't too much satisfactory for the needs for employment/job, but it is considered enough, i.e. useful in general.

**Table 4. Formal education and employment/job**

**Descriptive Statistics**

	N	Minimum	Maximum	Mean	Std. Deviation
Do you think that your last completed formal education gave the required knowledge/skills for your employment/job?	73	1	5	2,84	1,106
Valid N (listwise)	73				

According to table 5, the competency at work is at a high level, as most of the respondents consider that: *My job tasks very well correspondence with the skills I own – 19,2% and/or I have the competence to cope with more complex job tasks – 38,4%*, and only 9,6% who answered with: *I need extra training to cope with my job tasks.*

**Table 5. Competency at work**

**Which of the statements best describes your competency at work?**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	I need extra training to cope with my job tasks	7	9,6	9,6	9,6
	My job tasks very well correspondence with the skills i own	14	19,2	19,2	28,8
	I have the competence to cope with more complex job tasks	28	38,4	38,4	67,1
	I'm not employed	24	32,9	32,9	100,0
	Total	73	100,0	100,0	

The results (table 6.) show that both, the formal and the nonformal education are considered equally helpful for better coping with the changes.

**Table 6. Formal or nonformal education for better coping with the changes**

**Do you think that the formal/nonformal education can be helpful for better coping with changes?**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes, but more the formal education	12	16,4	16,4	16,4
	Yes, but more the nonformal education	10	13,7	13,7	30,1
	Both, in different way	49	67,1	67,1	97,3
	No	2	2,7	2,7	100,0
	Total	73	100,0	100,0	

The respondents were also asked what do they find as most prevailing when choosing their formal/nonformal education. And the results are ranked as: (1) quality/renomee with 57,5%; (2) educational program with 26%; (3) price with 13,7% and (4) location with only 2,7%.

**Table 7. Criteria for choosing a type of lifelong learning**

When choosing your formal/nonformal education, what do you find as most prevailing?

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Location	2	2,7	2,7	2,7
Quality/renomee	42	57,5	57,5	60,3
Price	10	13,7	13,7	74,0
Educational program	19	26,0	26,0	100,0
Total	73	100,0	100,0	

The respondents had to answer do they prefer to use their working time, time for leisure throughout the week, or free time for weekends, for educational purposes (table 8), and from the results, it can be concluded that most of them, 75,3% would like to use their time for leisure throughout the week. This is very important fact for the work vs. private life balance, i.e. for the total quality of working life.

**Table 8. Spending time for lifelong learning**

For education purposes, you prefer to use:

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid My working time	4	5,5	5,5	5,5
Time for leisure, through the week	55	75,3	75,3	80,8
My free time, at the weekends	14	19,2	19,2	100,0
Total	73	100,0	100,0	

About the issue of participation and finance investment in nonformal education/training program, the respondents were asked what do they prefer – either them to choose the training program, either their employer, and also – who to take on the costs for that. The results show that most of the respondents – 63% prefer to choose the training program by themselves, but that to be paid by the employer. It is a positive fact that even 27,4% are willing to choose and finance the training by themselves, and only 9,6% would rather let the complete decision to be made by the employer (table 9).

**Table 9. Choosing and financing the lifelong learning****When choosing nonformal education, what do you prefer?**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid To choose and finance the training program by yourself	20	27,4	27,4	27,4
To choose the program by yourself, financed by the employer	46	63,0	63,0	90,4
To get the traing that is chosen and financed by the employer	7	9,6	9,6	100,0
Total	73	100,0	100,0	

The results about the benefits and expectations from the current formal education (postgraduate studies in HRM), could be ranked in the following order: (1) Personal satisfaction/realization of personal aspirations/self fulfillment; (2) Opportunities for new employment; (3) Gaining knowledge, skills and competencies required for the job (4) Opportunities for career development/new, better position at work; (5) Active citizenship and social inclusion; (6) Keeping the job. At the question: Would you use your student status for educational mobility in EU, most of the respondents answered with yes – 42% (table 10).

**Table 10. Educational mobility****Would you use your student status for educational mobility in EU?**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid yes	42	57,5	57,5	57,5
no	13	17,8	17,8	75,3
don't know	18	24,7	24,7	100,0
Total	73	100,0	100,0	

The valorization of the certificate/diploma from the formal/nonformal educations turns to be a significant issue for working - mobility outside the country opportunities, as most of the respondents – 52% had a positive answer toward the question.

**Table 11. Working mobility**

**How much the valorization of the certificate/diploma from the formal/nonformal education is important to you for working mobility outside your country?**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid very important	32	43,8	43,8	43,8
important	6	8,2	8,2	52,1
important and unimportant	16	21,9	21,9	74,0
unimportant	8	11,0	11,0	84,9
unimportant at all	11	15,1	15,1	100,0
Total	73	100,0	100,0	

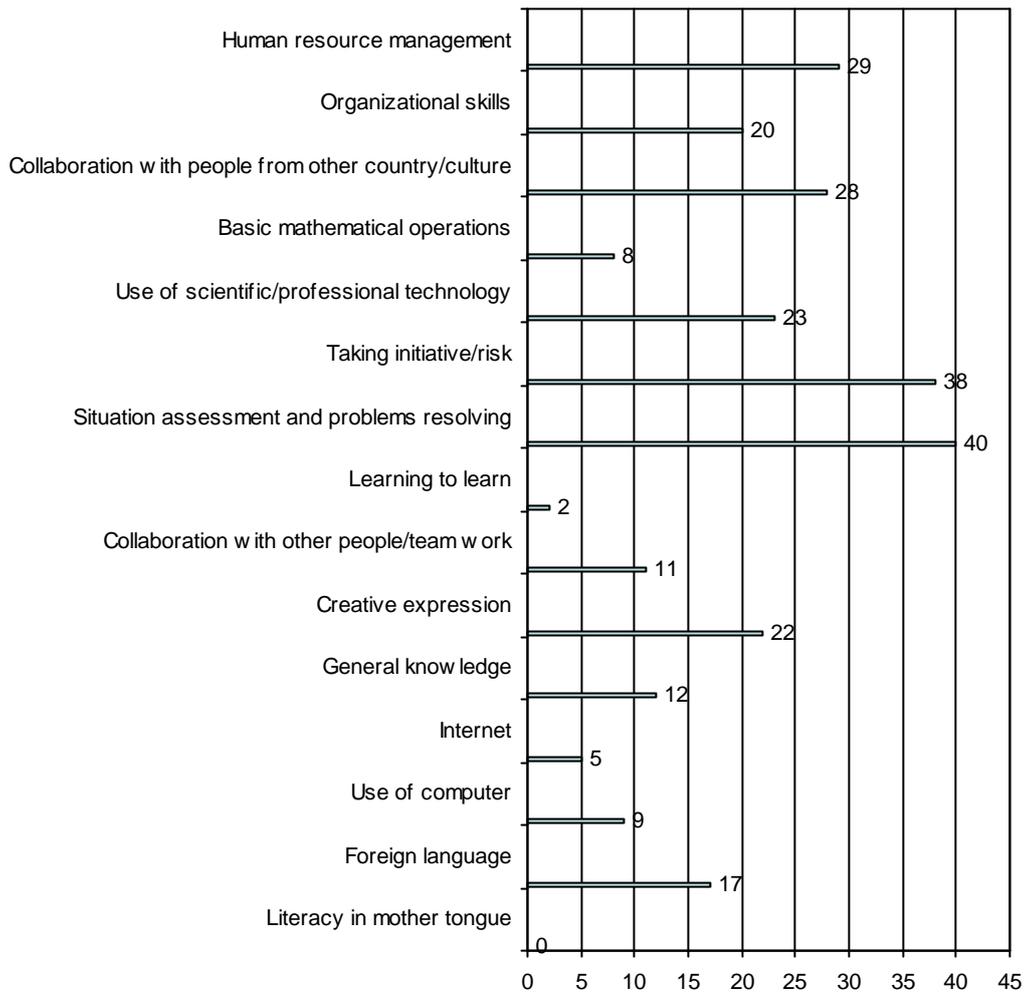
There is a distribution of positive answers in percentages of the respondents (table 12) about each of the key competence for LLL (through some extra sub-competences), which they personally find it necessary to gain or to improve.

The rank of the most required competences would be:

1. Situation assessment and problems resolving
2. Taking initiative/risk
3. Human resource management
4. Collaboration with people from other country/culture
5. Use of scientific/professional technology
6. Creative expression
7. Organizational skills
8. Foreign language
9. General knowledge
10. Collaboration with other people/team work
11. Use of computer
12. Basic mathematical operations
13. Internet
14. Learning to learn
15. Literacy in mother tongue

This should be accepted as meaningful information for the curricula development for the educational study programs. And it also shows the recognized need for entrepreneurial competences development.

**Figure 1. Required LLL competences**



And for that purpose, in order to improve/gain these competences, most of them – 53,4% would rather choose formal education, 38,4% would choose nonformal education/ training, and only 8,2% consider that the self-learning (by literature, audio-visual devices, internet etc.) would be the most useful way.

**Table 12. Competences development and lifelong learning form**

**In order to improve/gain these competencies, which form of education/learning do you consider the best?**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Formal education	39	53,4	53,4	53,4
Nonformal education	28	38,4	38,4	91,8
Self learning (literature, audio/visual devices, internet)	6	8,2	8,2	100,0
Total	73	100,0	100,0	

The respondents were directly asked, with open question, what would they suggest for improvement of the current educational programs, and the general highlights were: (a) focus on quality; (b) professors'/trainers' approach improvement; (c) less theory, more practice; (d) modernization; (e) learning practical things; (f) redefinition of the low regulative about LLL in the country; (g) verification of the non formal education.

#### **4. Conclusion**

As the results show, people can hardly cope with the 21. century changes in the world of work, but in the sphere of the everyday life also. The respondents have recognized their need for constant improvement and development, and their general opinion is that this type of knowledge, skills and competences could be gained by combining the both of the educational systems: formal and nonformal. As five most required competences they outline: situation assessment and problems resolving; taking initiative/risk; human resource management; collaboration with people from other country/culture; use of scientific/professional technology; from which can be concluded that the priority action should be directed to the lifelong learning for entrepreneurship; people skills development; and using technology.

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**Original scientific paper**

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**LIQUIDITY OF TOURISM SECTOR ENTERPRISES  
IN THE REPUBLIC OF MACEDONIA**

**Abstract**

This paper is focused on number of issues related to cash flow management and liquidity as a long-term problem of Macedonian tourism enterprises, having in mind that strong sales and profits do not ensure good cash flow and liquidity. The timing differences between accrual based profitability and cash flow means that even enterprise with growing sales and strong net income may run out of cash with ensuing disastrous results. This means that the enterprise needs to understand, project and manage its cash flow and liquidity very carefully.

In that purpose some activities on enterprises and institutional level are needed. Defined policy should contain activities for: faster cash making then expiring liabilities; realization of cash inflows vis a vis cash outflows with limited risk; dynamic liability covering and activities for education and training of labor force. Some possibilities for institutional capacity strengthening concerning realization of good cash and liquidity management are related to following activities: activities related to continuous adjustment of Macedonian legal framework; activities related to monetary and credit policy in direction to improvement of borrowing conditions; activities related to improvement of business environment.

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Cash flow and liquidity projecting is an indispensable part of enterprise's managing process. Without adequate projecting, the macedonian tourism enterprises can never sufficiently know what its cash flow and liquidity position will be at any particular time. With it, surprises will be mitigated and the enterprise will be able to plan how to handle any shortfalls or excesses. In that order the timing of the cash inflows and cash outflows has to be taken in to account.

**Key words:** Cash flow, liquidity, enterprises, tourism sector, Republic of Macedonia.

**JEL Classification:** G32

### **Introduction**

One of the main reasons for unfavorable performance results of tourism sector enterprise in the Republic of Macedonia is related to liquidity problem. Partly, this is problem caused as a consequence of weak applicative recommendations and solutions derived from the financial performance analyses in Macedonian economy, as well as of seasonality of tourism sector . While facing the problem on the enterprise level, it is obvious that the key for realizing and maintaining the sufficient level of liquidity is in good management of cash inflows and cash outflows. Thence, the need and importance of using company cash flow data in the managing process.

Real estimation of tourism enterprises' financial performances and results can not be done because of the time gap between the revenues and costs, analyzing the cash flows and cash outflows give appropriate point of view for appraisals. Further, the importance of cash flow is not only related to the favorable level of company liquidity, but its crucial mean for: enterprise lasting on a competitive market, attraction of foreign and domestic investors, business expanding, functioning and development, also.

## **1. Cash flow in relationship to liquidity**

Cash flow and liquidity interrelation can be explained in logic of comparing available current assets and short-term liabilities as factors of short-term liquidity, on one hand. On the other hand, long-term liquidity is a result of comparison of enterprise financial ability for reconstruction of current and building of new capacities and enterprise generating cash flow possibility for repayment of debt regarding this activities, which also means to compensate enterprise own funds used for that purpose.

All above mentioned financial items and changes content in the cash flow financial statement have a direct impact on the liquidity status of tourism enterprises. "Companies could take the view that cash flows are critically important and that a regular reports of actual cash flows and balances, compared with budgets and a regularly revised forecast, are essential to ensure that company remains within its funding limits".<sup>1</sup>

In general, the enterprise has a good liquidity in short-term if cash inflows from operating activities are exceeding cash outflows from the same activities, or it has the financial basic for permanent functioning of operating activities and from time to time possibility to create financial funds for investment activities in the next period. On contrary, it might cause problems in enterprise functioning and it won't be able to pay for accounts payable on time, especially in case of seasonal character of tourism enterprises.

Long-term liquidity level depends on cash inflows and cash outflows from all types of activities (operating, financial and investment). If the difference between cash flows and cash outflows is for cash flows benefit, there are conditions for financial funds creation and opportunities for investment activities intensification. In that case the level of liquidity is stabile. On contrary, enterprise has liquidity problem. As long as the cash flows from all types of activities are covering cash outflows from operating activities only, that enterprise has short-term good liquidity without long-term possibility for its maintaining and business expanding. The above mentioned gives sign for different points of view that should be taken into consideration when analyzing statement of cash flow. Presented data and information in this statement are fundamental for

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<sup>1</sup> Graham Alistair, Graham Alastair: Cash flow forecasting and liquidity, Chartered Institute of Bankers Publishing, United Kingdom, 2000, p. 33.

current liquidity estimation and opportunities for its improvement in a short or longer period of time.

In sense of cash flow and liquidity interrelation, net cash flow from operating, financial and investment tourism enterprise activities deserve special attention. “Cash should come from operations and should be used for investing, with financing as the balancing number”.<sup>2</sup> This approach provides information for separate activities contribution (positive or negative) in cash flow and liquidity, in different periods of time. Priorities in future period will be on those activities with more positive influence, having on mind the role of investment activities as a prerequisites for future better cash flow and liquidity in a longer period of time.

## **2. Liquidity as a separate long-term problem in tourism sector enterprises**

Managing liquidity as one of the main principles in creation and realization of enterprise financial policy is a very complex process. Conditions for maintenance of stabile enterprise liquidity presume financial balance between tangible assets and appropriate sources for them. In that order, there is a need for many different activities in the permanent functioning process of tourism enterprises that may be limited in the proceedings.

**Table 1. Liquidity indicators of tourism sector enterprises in the Republic of Macedonia (2007-2011)**

In%

<b>Indicators</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
Curent liquidity	0,6	0,6	0,78	0,77	0,72
Moment liquidity	0,4	0,4	0,63	0,63	0,58
Quck liquidity	0,1	0,1	0,11	0,33	0,32

Sorce: Financial stability report of the Republic of Macedonia for 2008, 2010 and 2011.

<sup>2</sup> Rob Reider, Peter B. Heyler: *Managing cash flow – an operational focus*, John Wiley & Sons, Inc, New Jersey, 2003, p.313.

**Table 2. Indicators for efficiency of assets utilization of tourism sector enterprises in the Republic of Macedonia (2007-2011)**

<b>Indicators</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
Average collection period	27	30	105	92	80
Average inventory period	21	23	45	42	40
Average payment period	105	119	283	299	286
Turnover of accounts receivable	13,52	12,17	3,48	3,96	4,53
Turnover of inventory	17,38	15,87	8,11	8,74	9,09
Turnover of total assets	0,41	0,40	0,43	0,43	0,48

Source: Financial stability report of the Republic of Macedonia for 2008, 2010 and 2011.

In spite of the above-mentioned financial indiscipline and problem with payment delaying, there are other significant long-term problems closely related to liquidity of tourism sector enterprises, as:

- ***Insufficient acknowledgements for the liquidity importance in creation and realization of tourism enterprise financial policy***, that has unfavorable impact on the total economy liquidity;
- ***Insufficient participation of liquidity planning process in tourism sector enterprises***, that limits the good prediction of future cash inflows and cash outflows;
- ***Lack of liabilities (short-term and long-term capital) and their unfavorable structure***. In one longer period of time macedonian tourism enterprises are facing the lack of capital that causes liquidity problems. The low level of liquidity enlarges the number of unsolved debts among enterprises and influences their ability for investment, as a good presume for generating cash flow. The lack of long-term capital might be covered by borrowings that in final cause higher financial costs for rates;

- **Low level of revenue and its seasonal collection in tourism enterprises and high level of fixed costs during the whole year;**
- **High interest rates of credits in the Republic of Macedonia** and other rigorous conditions for borrowing capital are separate problem related to liquidity. “Before borrowing from external sources, a cash manager should also explore all internal sources of funds. These could include increasing sales, accelerating accounts receivable and collections, reducing inventory, improving accounts payable management, reducing expenses, and selling nonessential assets”;<sup>3</sup>
- **Financial indiscipline** is another problem already mentioned in previous context;
- **Low level of Macedonian economy development** is one and very important issue with negative influence on cash flow generation that also influence the tourism enterprise income and cash accumulation as a prerequisites for favorable liquidity maintenance;
- **Need for trainings in Macedonian enterprises** regarding the preparation methodology of cash flow statement and its analyze according to contemporary financial literature.

In general these are main problems with long-term negative influence on Macedonian tourism enterprise liquidity. In spite of this, depending of enterprises feature and their activity, there are other factors with long-term or short-term influence. For these obstacles to be overcome, additional steps are required on enterprise level as well as legislative adjustment and institutional capacity strengthening, concerning financial performance of enterprises.

### **3. Possibilities for efficient cash and liquidity management on enterprise level in tourism sector**

As we mentioned above, liquidity is a financial balance between the cash inflows and cash outflows or cash and expiring liabilities in one

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<sup>3</sup> Allman-Ward Michele, Sagner James: Essentials of managing corporate cash, John Wiley & Sons Inc., 2003, p.115.

period of time. Consequently, if enterprises don't predict the amount of expected cash inflows and outflows and other financial closely related activities it may cause unstable liquidity, risk for insolvency and need for capital borrowing, also.

In that order, it is very important to choose a projecting method and in considering which techniques to use, enterprises have to weigh a number of factors, as following:

- Availability of data-using information that is readily available makes it possible for the enterprise to produce a timely forecast. Unfortunately, businesses typically do not maintain data in formats that allow easy access for statistical analysis.
- Reliability of data- in projecting process, cash flow and liquidity manager will have top access the probability of being correct about the timing of cash flows. For that purpose they should take in to consideration so called: assured cash flows (for example: tax payments, maturing investments, dividends etc.); reliable cash flows (for example: collections from credit sales, vendor payments etc); unreliable cash flows (for example: costs of work stoppages, foreign currency collections etc.); and unanticipated cash flows (for example: cash flows resulting from totally unexpected circumstances such as a outbreak of war in an area where the enterprise is involved, opportunity to buy due to a competitor going out of business etc.).
- Time horizon – the more distant in time the prediction, the less accurate and the less useful it becomes to the cash and liquidity manager. They need to make sure that the time horizon for the prediction is appropriate for the intended purpose.
- Sensitivity – cash and liquidity managers must be prepared to review, refine, and adjust the projection frequently in light of external and internal amendments.

Concerning the projection of cash inflows and cash outflows and the liquidity in macedonian tourism enterprises, the basic direction is determination of real policy for cash flow generation and liquidity maintenance. Namely, defined policy should contain activities for:

- ***Faster cash making then expiring liabilities***, which also means the amount of cash to overcome the liabilities in a period of time. That shows not only the efficiency but also ensure the full stability of enterprise liquidity, with cash accumulation for any case (cash reserve).
- ***Realization of cash inflows that overcome the amount of cash outflows with limited risk*** because of a lower cash reserve than in a previous case. In such a situation, in spite of the efficient cash and liquidity management, the principle of enterprise cost-effectiveness is also taken into consideration.
- ***Dynamic liability covering***, dynamic adjustment between the cash inflows and cash outflows. Activities directed to permanent realization of collections in contribution to risk reduction. The extended tourism season is the activity that can contribute in that way.
- ***Activities concerning the financial performances and ability for paying of business partners*** (collection of permanent and potential business partner's liquidity data) will contribute to improvement in this area, also.
- ***Activities for education and training of labor force engaged in macedonian tourism enterprises*** will have significant positive effects on efficient cash and liquidity management.

Cash and liquidity management is very complex and as such process needs engagement of different profiles of human recourses. Besides the financial management activities, activities from other enterprises departments might have crucial direct or indirect influence on cash flow generation and projected liquidity realization.

#### **4. Recommendations for efficient cash and liquidity management towards the institutional capacity strengthening**

Having this in mind, some activities should be undertaken besides of above-mentioned aspects of possibilities for cash flow generation and liquidity achievement and maintenance in Macedonian tourism enterprises. Efficient cash and liquidity management is influenced by

present systematic and legal framework related to these issues, also, made by all relevant institutions, toward making more favorable conditions for efficiency empowerment of cash and liquidity management.

There are different possibilities for institutional capacity strengthening concerning realization of good cash and liquidity management. Some of them are more significant and they are related to the activities regarding the following:

- ***Activities related to continuous adjustment of Macedonian legal framework*** (concerning financial management in Macedonian enterprises) to the modifications and additions in the International Accounting Standards. In that context, we should emphasize the need for obligatory preparation of financial statements by all legal entities of Macedonian economy. As we already mentioned, that is not the present situation in the Republic of Macedonia, although there is background for legislate this settlement in standing International Accounting Standards.
- ***Activities related to monetary and credit policy in direction to improvement of borrowing conditions.*** It is well known, that the Macedonian enterprises, as a result of high interest rates, have significant operative costs. That has a negative influence on increase of enterprise expenditures at all, and respectively results to net income decrease as a own source for liquidity maintenance.
- ***Activities related to improvement of business environment as a whole.*** Those activities are directed to tariff reducing; free capital flow, legal security and appropriate guaranties, business credit approval under the favorable conditions, etc.

Realization of those activities indirectly will contribute to achieve better business performance of Macedonian legal entities, as well as in tourism sector enterprise and consequently achievement of greater liquidity level, witch, as we already conclude is very low at present.

It is obvious that managing cash flow is a continual process. So, beside of above-mentioned potential activities, other more specific measures concerning the different circumstances in future can be recommended by relevant institutions, agencies and organizations in the Republic of Macedonia.

## **Conclusion**

Managing cash and liquidity is arguably more important than the managing profitability, working capital, or assets and liabilities, because having enough cash is a survival issue of immediate importance. Issues involved in cash and liquidity management can be difficult to manage, including that of how much cash to maintain for operating purposes. Too, little cash is an obvious problem for enterprises liquidity and survival, but maintaining too much is also problematic inasmuch as that means insufficient utilization of scarce enterprise resources. Cash like accounts receivable, inventory, plant and equipment, needs to work for enterprise in order to optimize return on the investment in all assets of the organization.

Cash flow and liquidity projecting is an indispensable part of enterprise's managing process. Without adequate projecting, the enterprise in tourism sector can never sufficiently know what its cash flow and liquidity position will be at any particular time. With it, surprises will be mitigated and the tourism enterprise will be able to plan how to handle any shortfalls or excesses during the whole year. In that order the timing of the cash inflows and cash outflows has to be taken in to account. This requires the enterprise to understand the timing of cash inflows, relative to sales made and the timing of cash outflows relative to when the expenses are actually occurred.

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**Original scientific paper**

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**PERSONNEL COSTS MANAGEMENT IN BANKING–CASE  
OF THE MACEDONIAN BANKING SECTOR**

**Abstract**

The overall development and outcomes of business entities are primarily dependent on the adequate principles of human resource management. This presents the main reason for the classification of staff costs as one of the most specific expenditure categories in modern and dynamic business environment.

As successful personnel costs management could be identified an optimal balance establishment between the shareholders, management and employees interests, in order to reach long-term stability, growth and sustainable development of commercial banks. The identification of the key variables that affect the personal costs as an expenditure category, leads to improved analysis on banking institutions and consequently to more accurate management decisions and actions.

In the research study on the case of banking sector in Macedonia, was found that the share of personnel costs in the category of non-interest expenses depends on: capital adequacy ratio, rate of capital and reserves in total assets, share of highly liquid assets in total assets, as well as the business results presented through profitability indicators ROAE and ROAA. However the results may vary if the tests are performed on different groups of banks as well as on the individual bank institutions level. Adopted to the specific features of individual banks and combined with other banking models, this model could be a useful additional analytical tool in bank management information systems.

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**Key words:** Banks, human resources, personal costs, model.

**JEL classification:** G21

### **Introduction**

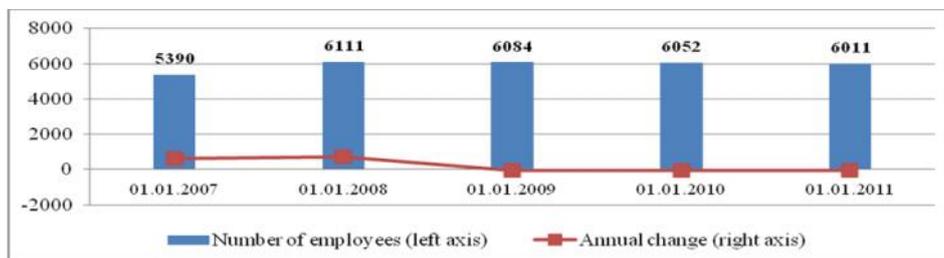
In our recent research activities related to the situation in Macedonian banking sector, we constituted alternative models in terms of: development of a new products for retail banking customers (Poposka, Trpkoski, 2013, March), analyses of the risks for banking sector connected to the companies in the construction industry (Poposka, Trpkoski, 2013, April) as well as secondary model for capital adequacy management connected with implementation of the new Basel 3 standards (Poposka, Trpkoski, 2013, May). The model in this paper identifies the key variables that are significant for the rate of share of personnel costs in total amount of non-interest expenses in Macedonian banking sector, as a segment which is not covered with our previous research papers.

On global level, developments in the banking sector in recent years, points to the need of increased cost effectiveness in all business processes, activities and decisions. Banks are at a crossroads. Cutting costs through tactical efficiencies may be a winning short-term strategy, but beating the competition long term requires structural change (Accenture 2008). As a segment of cost optimization solutions, some banks have traditionally viewed call centers as a means to cut costs or improve customer satisfaction but this channel has failed to deliver on both of these missions. Some of them are considering to reduce this channel cost by moving more transactions to self-service options; others are aiming to make it profit center that drives sales growth and a number of banks are doing both (Gupta, McMahon, Jain & Kanagasabai, 2008). Other banks as one of the possible cost effectiveness strategies, found outsourcing of their non-core processes to third party vendors. This could deliver the twin benefits of lower employee overheads and higher productivity among bank employees who could focus their energies on the core business (Jaymalya Palit, 2007).

Human resources are the major assets of all business entities. However, they represent one of the key cost categories of commercial banks. Compared to other types of non-interest expenses, the

shareholders views for this group of costs are often inconsistent. The shareholders aim to reduce the cost of human resources. Contrary, employees always have demands for higher wages and benefits. The management in order to establish a balance between the two groups must respond to a number of challenges from internal and external nature. The dynamics of the movement in the number of employees in the Macedonian banking sector is given by Graph 1.

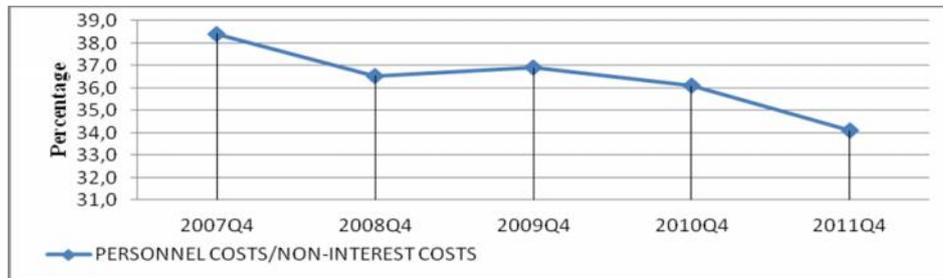
**Graph1. Employment in the Macedonian banking sector**



Source: NBRM (2012), Annual report for the banking sector in Republic of Macedonia for 2011, [www.nbrm.mk](http://www.nbrm.mk).

Based on the data presented by Graph 1, it can be concluded that the number of employees in the banking sector in the country has seen significant growth in period 2007-2008, while in the period 2008-2011, a decreasing trend. Here arises the following dilemma – Is the change in the number of employees affects the rate of participation of personnel costs in the total amount of non-interest expenses of the banking sector? The answer may be partly found analyzing the Graph 2.

**Graph2. Personnel costs in the Macedonian banking sector and their share in the total amount of non-interest expenses**



Source: NBRM (2012), Own calculations based upon the data from the report " Indicators for financial stability of Macedonian banking system in Republic of Macedonia for the period 2001-2012", [www.nbrm.mk](http://www.nbrm.mk).

Graph 1 and 2 presents only a general picture for the movement of the number of employee's and the share of this costs category in the total amount of non-interest expenses. However, many other questions arise, which initiate further analysis such as:

1. Whether the category of bank customers (retail or business subjects) affects the level of expenditures for human resources?
2. Determination of the relationship (if any) between the level of capitalization and rate of share of personnel costs in the total amount of non-interest costs in banking?
3. Whether the trends on key profitability indicators (ROA and ROE) lead to an increase or decrease in the costs of human resources and if so, in which direction?
4. Whether the processes of non-performing loans collection are realized through internal resources or external service providers e.g. outsourcing agencies?
5. Whether staff expenses adequately follow the business dynamics of the banks?

Some of these challenges will be a subject to a secondary model for personnel costs management, presented in the following parts of this paper. Finding appropriate responses to these questions, shall improve the management information systems with useful data that presents on step forward in making better and more rational business decisions in bank management.

## **1. Identification of variables and expected statistical effects**

The human resources present a key component for development, competitiveness and success of all business entities. Personnel expenditures in general are connected to salaries for employees and other benefits as well as the costs associated with training and other types of investments in human resources.

For gaining sustainable competitive advantage e.g. Efficiency, Innovation and Responsiveness, it's highly recommended that organizations (especially those that activates in the financial services sector) should attend to the empowerment of employees in the appropriate form (Mohammad Safari Kahreh, Heidar Ahmadi and Asgar Hashemi, 2011).

The significance of the individual variables that affect the cost of staff of commercial banks primarily depends by the individual strategy of each bank. Certain banks are focused on market share increasing, others towards achieving a higher rate of on equity return (ROE) or increased rate of return on assets (ROA), focusing on stability goals through maintaining high level of capital adequacy, targeting different category of customers (retail or corporate clients) in order to reach lower risk profile etc.

Regarding the above mentioned information on the rate of share of personnel costs in the total amount of non-interest expenses, the following variables are expected to have statistical influence:

1. **Retail loans/gross loans to nonfinancial entities**– it's expected that through the tests of this variable an answer would be reached connected to the dilemma whether the focus on particular category of customers (in this case retail clients), increases or reduces the share of personnel costs in the total amount of non-interest expenses? An reasonable expectation is that if banking sector notes tendency of increase in the share of loans to individual clients in the total loans to N.F.E., the rate of participation of personnel costs in total amount of non-interest expenses would also increase as a result of the higher number of employees in the selling and products maintaining and managing activities;
2. **Business loans/gross loans to nonfinancial entities**–The expectations about the impact of this variable on the share of personnel costs in the total amount of non-interest expenses are

contrary to the expectations for the impact of variable **retail loans/gross loans to nonfinancial entities**;

3. **Capital adequacy ratio coefficient**– through the tests of this variable information about the impact of capital adequacy on the dependent variable would be obtained;
4. **Non-performing loans/gross loans to nonfinancial entities**–the increase of the share of non-performing loans could initiate hiring of additional personnel in delinquency portfolio management which leads to higher personnel costs. On the other hand, if banks decided to use services from external agencies, the rate of share of personnel costs could decline relative to the total amount of non-interest expenses;
5. **Capital and reserves/total assets**– the change in participation rate of equity in total assets could affect the perception of stakeholders and their directions to bank managing boards in the segment of human resource policy;
6. **Highly liquid assets/total assets** – it's expected that banks which have higher fast liquidity coefficient, didn't spend a significant portion of their human resources capacity for intensive daily asset management activities. As a result it's considered that this variable would be moving in the opposite direction from the movement of the rate of share of personnel costs in the total amount of non-interest expenses;
7. **ROAE** – the lower rate of return on average equity rate could stimulate firing of employees in order to reach improved costs efficiency. The secondary model should answer the question whether banks improve their cost effectiveness by reducing expenditures for human resources of through optimization of other types of non-interest expenses.
8. **ROAA**– we cannot predict how the movement of this variable would affect the share of personnel costs in the total amount of non-interest expenses of the banks in Macedonian economy.

The methods for analyses on the statistical data and model specification are given in the next section of this research paper.

## **2. Statistical data and model specification**

The testing data for the model are taken from the report “Indicators of financial stability of the banking system of Republic of Macedonia in the period 2001-2012” published on the website of the National Bank of Republic of Macedonia. Some of the performed tests on the econometric relevance of the model are presented in the Annexure part of this paper.

The data processing activities will be performed by multiple regression analysis through application of the least squares method presented with the following mathematical equation:

$$y = b_0 + b_1x_1 + b_2x_2 + b_3x_3 + b_4x_4 + b_5x_5 + b_6x_6 + b_7x_7 + b_8x_8 + u$$

$b_0 - b_8$  -coefficients of the individual variables in the model

$x_1 = \text{RETAIL LOANS} / \text{GROSS LOANS TO NONFINANCIAL ENTITIES}$

$x_2 = \text{BUSINESS LOANS} / \text{GROSS LOANS TO NONFINANCIAL ENTITIES}$

$x_3 = \text{CAPITAL ADEQUACY RATIO}$

$x_4 = \text{NON - PERFORMING LOANS} / \text{GROSS LOANS TO NONFINANCIAL ENTITIES}$

$x_5 = \text{CAPITAL AND RESERVES} / \text{TOTAL ASSETS}$

$x_6 = \text{HIGHLY LIQUID ASSETS} / \text{TOTAL ASSETS}$

$x_7 = \text{ROAE}$

$x_8 = \text{ROAA}$

$u = \text{STOCHASTIC ERROR} - \text{random error.}$

The effects of the identified independent variables on the rate of share of human resource expenditures in the total amount of non-interest bank expenses are analyzed in the following part of this research study.

## **3. Analysis of the results**

The regression analyze results are presented in Table 1, while the realized control tests of the model parameters from econometrical point of view in the Annexure section of this paper.

**Table 1**  
**Results of regression analysis of the independent variables impact on PERSONNEL COSTS/NON-INTEREST COSTS for the period Q42001 – Q32012**

Dependent Variable: PERSONNEL COSTS/NON-INTEREST COSTS  
 Method: Least Squares  
 Date: 03/20/13 Time: 23:42  
 Sample: 2001Q4 2012Q3  
 Included observations: 32

Variable	Coefficient	Std. Error	t-Statistic	Prob.
RETAIL LOANS/GROSS LOANS TO N.F.E.	0.231981	0.219174	1.058433	0.3008
BUSINESS LOANS/GROSS LOANS TO N.F.E.	-0.007558	0.279309	-0.027059	0.9786
CAPITAL ADEQUACY RATIO	0.803438	0.335929	<b>2.391693</b>	<b>0.0253</b>
NON-PERFORMING LOANS/GROSS LOANS	0.614071	0.359376	1.708715	0.1010
CAPITAL AND RESERVES/TOTAL ASSETS	-2.013544	0.954925	<b>-2.108589</b>	<b>0.0461</b>
HIGHLY LIQUID ASSETS/TOTAL ASSETS	-0.501952	0.166853	<b>-3.008343</b>	<b>0.0063</b>
ROAE	-1.305465	0.318748	<b>-4.095598</b>	<b>0.0004</b>
ROAA	12.26165	2.392488	<b>5.125064</b>	<b>0.0000</b>
C	42.37749	26.66554	1.589223	0.1257
R-squared	<b>0.893883</b>	Mean dependent var		37.14085
Adjusted R-squared	0.856973	S.D. dependent var		2.817752
S.E. of regression	1.065643	Akaike info criterion		3.197291
Sum squared resid	26.11866	Schwarz criterion		3.609530
Log likelihood	-42.15666	Hannan-Quinn criter.		3.333937
F-statistic	<b>24.21781</b>	Durbin-Watson stat		<b>1.888735</b>
Prob(F-statistic)	0.000000			

Source: Individual calculations based on the time series data for the banking sector, published by National Bank of Macedonia.

If the values from Table 1 are integrated into previously presented formula, the equation would have the following design:

$$y = 42.37749x_0 + 0.231981x_1 - 0.007558x_2 + 0.803438x_3 + 0.614071x_4 - 2.013544x_5 - 0.501952x_6 - 1.305465x_7 + 12.26165x_8 + u$$

The coefficients b0, b1, b3, b4 and b8 have a positive impact on the variable PERSONNEL COSTS/NON-FINANCIAL COSTS, while the coefficients b2, b5, b6 and b7 negative impact on the dependent variable.

Through p values, could be concluded that the independent variables RETAIL LOANS/GROSS LOANS TO N.F.E. and BUSINESS LOANS/GROSS LOANS TO N.F.E. do not have statistical influence on the dependent variable PERSONNEL COSTS/NON-INTEREST COSTS.

The model presents that variable NON-PERFORMING LOANS/GROSS LOANS is statistically insignificant for the dependent variable, which to some extent is contrary to the previous expectations. Although these independent variables in the tests didn't have statistical significance, we consider that for complete confirmation of this conclusion more tests should be performed primarily on the level on different group of banks as well as on level on individual bank institutions, for statistically relevant period of observations.

The model presents that variable: CAPITAL ADEQUACY RATIO and ROAA have a positive statistical impact on the dependent variable, while independent variables CAPITAL AND RESERVES/TOTAL ASSETS, HIGHLY LIQUID ASSETS/TOTAL ASSETS and ROAE, a negative statistical influence on dependent variable.

The value of R-squared (0.893883), presents that independent variables with CCA 89% determine the dependent variable which is acceptable result from statistical point of view. In the same time autocorrelation parameter presented with the value of Durbin-Watson statistics (1.888735) is in the proper range which means that the model is satisfactory and relevant in this part of the tests.

## **Discussion and conclusion**

Based on the results of the secondary model, it can be concluded that personnel costs do not depend from the rate of participation of loans to retail clients or legal entities in total loans to non-financial entities issued by the banks. This conclusion to some extent is contrary to initial expectations. However, these results are related to whole banking sector and they do not necessarily reflect the situation in all individual banks.

The model presents information that the movement in the CAPITAL ADEQUACY RATIO ((Tier 1 + Tier 2)/Risk Weighted Assets) on Macedonian banks, has proportional trend with the share of the personnel costs in total amount of non-interest costs, while that the variable CAPITAL AND RESERVES/TOTAL ASSETS a reverse movement from the direction of the dependent variable. The statistical impact of these two independent variables opens a new dilemma and suggests further analysis for more accurate identification of the main reasons for these results. As a part of the further challenges, could be identified:

1. Determination of the relationship between the capital adequacy ratio and the intensity and primarily objectives of the costs optimization activities;
2. The determination of the relationship between the share of TIER 2 and management freedom for business decisions connected to the number of employments and personnel costs could be identified as other challenge;
3. Some of the Macedonian banks could take higher risks if they managed with higher amount of capital from secondary sources (TIER 2). In the same time managing boards of these institutions could be empowered with higher freedom in asset and liabilities management. This capital could lead to market expansion activities and growing tendency of personnel costs (which would follow the business dynamics). The share of own capital and reserves in total assets in these circumstances are logically moving in the opposite direction from the dependent variable.

The model presented that the variable HIGH LIQUIDITY/TOTAL ASSETS has opposite direction from the dependent variable PERSONNEL COSTS/NON-INTEREST COSTS. Lower liquidity rate leads to more intensive activities by staff in the

segment of asset and liability management. Banks with lower high liquid assets are using more of their staff capacity in order to reach an adequately asset and liability management.

The rate on average capital returns (ROAE) has an opposite movement from the share of personnel costs in the total amount of non-interest costs, while the variable ROAA proportional trend to the same dependent variable.

Lower rate of ROAE could lead to growing in staff number arranged into activities connected to delinquency portfolio operations. According to the results of the secondary model, as a general conclusion could be mentioned that Macedonian banks are using more internal resources than external agencies for delinquency portfolio management services, because in the opposite case, other types of non-interest costs should be growing which would lead to lower rate of the share of the personnel costs in the total amount of non-interest expenditures.

The results obtained on the level of banking sector don't have to reflect the individual condition for all banks in the country. Namely, we suggest that for more accurate results, the model should be used in combination with other banking models on the level on each individual bank.

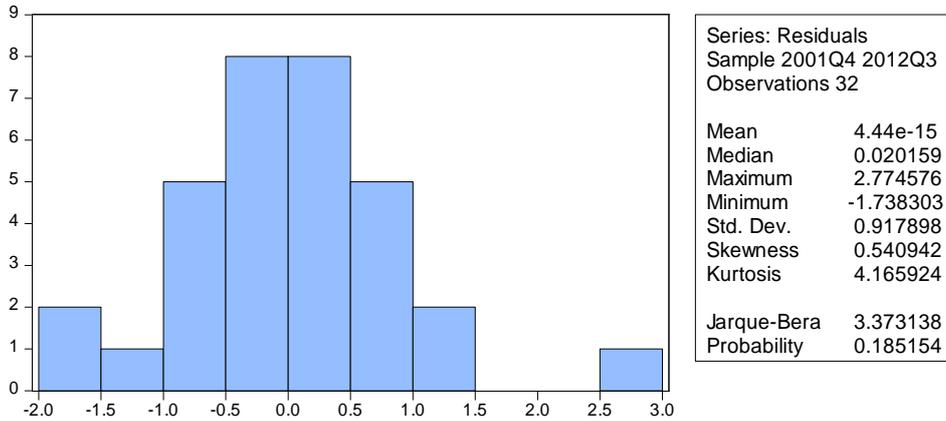
The tests of the model on the level on each individual bank could provide more adequately confirmation or rejection on the results from the tests. It's considered that the model could present interesting information for the bank management for the comparative analysis purposes. Due to the lack of relevant academic and practical literature linked with the topic of this research, for accurately confirmation of the results obtained through the secondary model, more empirical tests should be performed.

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**Annexure:  
Appendix 1**

Results from Jarque - Bera test:



**Appendix 2**

Segment of the results from Breusch-Godfrey Serial Correlation  
LM Test:

F-statistic	0.028050	Prob. F(2,21)	0.9724
Obs*R-squared	0.085259	Prob. Chi-Square(2)	<b>0.9583</b>

**Appendix 3**

Segment of the results from Heteroskedasticity Test: Breusch-Pagan-  
Godfrey

F-statistic	0.471146	Prob. F(8,23)	0.8638
Obs*R-squared	4.505683	Prob. Chi-Square(8)	<b>0.8089</b>
Scaled explained SS	3.684571	Prob. Chi-Square(8)	0.8844

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**Original scientific paper**

**Tatjana NESTOROVSKA<sup>1)</sup>**

**EFFECTS FROM THE IMPLEMENTATION OF A STRATEGY  
FOR RISK MANAGEMENT AND APPLICATION OF INTERNAL  
AUDIT AND CONTROL IN PUBLIC SECTION OF REPUBLIC  
OF MACEDONIA**

**Abstract**

Internal audit is an independent activity of obtaining an objective persuasion and advice established in order to contribute for increasing of the value and improvement of the working of the entity. It helps the entity to fulfill its aims by applying systematic, disciplined approach for evaluation and improvement of the effectiveness in the processes of risk management, control and management. Internal audit is consisted of analyses, evaluation, giving recommendation, information and advices for the activities which will be checked and the aim due to which it is done the effective, financial management and control with reasonable expenses.

The business entities which belong to the public section and the units of the local self government should make a control strategy corresponding to the strategies, policies and programs passed for the aim achievement. The success of the internal audit and its contribution in the work depends whether it sufficiently concentrates to the critical risks at business entities. The key task of the internal audit is to secure independent and objective evaluation of the system of internal control in public section.

**Key words:** internal audit, strategy, risks, public section, implementation

**JEL classification:** G32

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## **1. Risks and implementation of a strategy for risk reduction – important characteristics for ELS and business entities from the public section**

Risk is probability from happening of an event with negative influence of the aims achievement by the units of self government. Risk is uncertainty of the result, regardless whether it is positive possibility or negative danger, which could influence the capability of the municipalities in achievement of its aims. From the aspect of the basic authorities of the municipalities defined by the Constitution and the laws, the risk is a probability, that is to say, something which will distract the appropriate application of the legal regulations which realization is in their authority. From the aspect of the units of the self-government ELS and the public section, the risk also represents the possibility, the management of the administration and the public services as a whole regularly, transparently, economically, efficiently and effectively not to realize the programs, plans decisions and other acts reached by the Counsel of the municipalities.

Primary characteristics of the risk are:

- the risk is partially unknown
- the risk is changed due time
- the risk can be predicted and
- the risk can be managed

The risk is qualified as a strategic risk which has the influence in the achievement of the average and long term aims of the administration and the operational risk connected to the daily activities of the employees.

In order the cases of risk to be put to minimum, the risk management is used as a technique for more efficient confirmation of priorities and maintenance of the balance between controls and the security of corresponding services to the citizens.

Management of risk covers confirmation, evaluation and control of the possible events or conditions which can have negative influence to the achievement of the aims of the entity from the public section due to securing reasonable persuasion that the aims will be achieved. The securing of the efficient cooperation with risks especially is important in conditions of changed role of the municipalities where the citizens

directly and through representatives participate in the decision for the following issues: public services, urbanism and the rural planning, communal activities, culture, sport, social and child protection, education, health care and in other areas confirmed by law.

Management with risks is a process of confirmation and evaluation of the internal and external risks which can negatively influence to the fulfillment of the aims of the municipalities and conduction of the necessary controls in order the risk display to be on an acceptable level or to reduce the consequences from the possible risks on an acceptable level.

The mayor of municipalities and the managers of the business entities in the public section are responsible for risk management and introduction of corresponding and efficient internal controls that are liable and transparent for achievement of the aims of the municipalities through management with public means of legal, economic, efficient and effective way<sup>2</sup>.

With the strategy the way of risk management is secured and conduction of the control as well as obligatory activities which will be taken in order to avoid or reduce the risks.

In order the cases of risks to be put to minimum, the risk management is used as a technique for more efficient confirmation of the priorities and maintenance of balance between controls and security of corresponding services of the citizens.

Risk management represents systematic management and application of all measurements necessary for limitation of risks. This includes the activities such as: data collection and information risks, analyses and their evaluation, confirmation and relation of measurements and regular checking (monitoring) of results from the taken measurements.

Risks management is a strategic instrument which is an important part of the efficient and effective management and planning.

**Strategy for risk management** represents a document which contains basic aims and direction for taking and risk management.

Strategy for risk management should be compositional part from the business working of each unit of the local self government and of each business entity especially those which belong to the public section.

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<sup>2</sup> Article 7 of the Law of Public Internal Financial Control( Official Gazette of RM number 90/09 and 12/11)

## **2. The necessity and effects of the introduction of the internal control in the public section**

The expectation of citizens everywhere in the world is rational, economical efficient and effective using of the disposable means by the public services. Also, from the public services is requested to be liable and transparent after execution of the given takes and services that are of public interest. The general aim of the policy of each country is obtaining public services which will be acceptable and qualitative and which will be oriented to the citizens and directed to positive results. That is why, it is necessary through cooperation between the institutions from the public section to secure one systematic approach for efficient measuring so that the conduction of the program and projects which are of public interest to be efficient and effective.

Internal financial control represents basic and the most important form of control in public company and as such it is equally important for the management as well as for the auditors especially in the achievement of the aims.

According to one view: “In the developed market economies the system of internal control is identified with the whole of control financial and other systems established by the management, in order to (1) take care for normal and efficient way of working of the company; (2) to secure attachment to the management policy;(3) to protect the means and (4) to secure as much as possible larger competency and exactness of the registration”<sup>3</sup>.

The concept of Pubic Internal Financial Control has been developed by the European Commission. That concept also represents a strategy and it aims to secure an operational model which will promote the system of internal control, primarily in the public section in accordance to the international standards.

In order to achieve that progress, the countries candidates where Republic Macedonia belongs, should make reform of system of internal financial control in the public section. In Republic of Macedonia it is conducted through establishment of independent audit and development of the principles of manager’s liability. The system which will be passed after the reform will guarantee rational using of means by the public

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<sup>3</sup> Bozinovska-Lazarevska Z., Audit, Skopje: Faculty of Economics,2011,page 43

section, reduction of suspicions, irregularities and above all prevention from frauds and corruption.

With the development and implementation of internal audit in the public section, it will be achieved improvement in the efficiency and effectiveness of the services in non profit entities, the securing corresponding value for the invested money. By the internal audit it is also achieved larger liability of the managers in the expenditure of the allocated means.

The internal control in the public section can secure:

- Coordination with the laws, policies, regulations, plans and procedures
- Reliable and complete information regarding the financial working
- Efficient and effective working and use of the resources
- Property protection

After the notice for the serious irregularity or fraud the internal audit and the manager of the unit for internal audit will not discuss for the irregularity or the fraud with no one else beside the manger of the entity or the authorized organs. In a case of an emergency or absence of the corresponding persons, the internal auditor will inform the manger of the Central internal audit and will request emergently measures to be taken.

Internal control can help in the aim accomplishment of the public company, as well as to secure information for sufficient or insufficient progress in their achievement, but still it should not be expected that it will solve the problem in the management.

With the internal control aims can not be achieved, which accomplishment depends on the management that is why the internal control can not improve the bad management.

Before the process of the internal control starts, it should be known the current condition of the public company from the aspect of the standards for the internal control.

That is why it is necessary to make checking and evaluation of the functionally of the internal control. That checking is done in order to get confirmation whether internal control contributes for the aims achievement.

There are several ways of checking and evaluation of the efficiency of the internal control: direct control, expertise more complex

control through techniques of surveillance and interviews and methodology of self evaluation (the company from the public section evaluates the effectiveness by a control of the own activities).

In the process of internal control there are different approaches and methodologies but the most frequently used and the most known model of internal control is COSO model. This model has also been known as a COSO frame- Integrated frame and it was published in 1992 by the Committee of sponsored organizations of the National Commission for fraud financial reports in the USA: Internal control

The internal control in COSO frame has been defined as a process made by the Board of managers of the company management and other employees designed to secure reasonable persuasion regarding the achievement of the aims in four categories:

- Coordination to the legal and sub legal regulations
- Reliability of the financial and management reporting
- Efficiency and effectiveness of the working
- Ownership protection

The internal control according to the COSO report “depends on the human factor and due to inherent limitation of the control structure and the necessity to take into consideration the relative expenses and contributions of its function, it is real to expect that the internal control of the management of business entity to offer only reasonable and not absolute persuasion”<sup>4</sup> The efficiency of the internal control is corresponding only if it exists reliability in the preparation of the finical reports and if it acts according to the legal regulations.

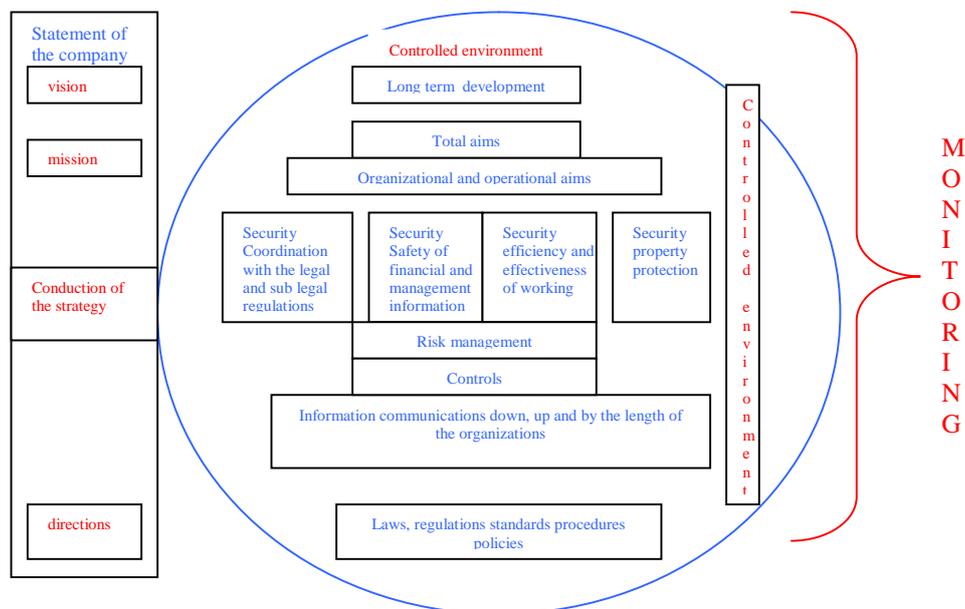
Internal control according to COSO frame is consisted of several components:<sup>5</sup> internal environment, risk management, controls, information, communication and monitoring. Similarly to COSO, the international financial standards in MSP 315 identify the following five components: control surrounding, process of entity risk evaluation, information risk, control activities and supervision of controls

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<sup>4</sup> Bozinovska-Lazarevska Z., Audit, Skopje: Faculty of Economics,2011,page 443

<sup>5</sup> [http://www.coso.org/documents/coso\\_erm\\_executivessummary.pdf](http://www.coso.org/documents/coso_erm_executivessummary.pdf) checked on 22.03.2012

**Picture 1 Five components of internal control**



**Source:** Section of internal financial control. Central unit for harmonization, Republic of Macedonia, Skopje, December 2010

The five components are inter-connected and in that way an integrated system has been created which reacts dynamically to the circumstances which are variable. Each business entity should take care, the system of internal control to be compositional part in everyday working activities and to represent liability to all employees.

### 3. Role of internal audit in the process of risk management

For the improvement of the work of public company it is necessary to make internal audit. The internal audit represents corresponding, independent and objective activity, by which professional opinion is given which is directed to the improvement and modeling of the company working. The internal control represents basis and the most important form of control in the company and as such it is equally important for the organs of management as well as for the audit,

especially at the execution of its tasks<sup>6</sup>. Also, such audit helps the company to achieve its aims with the introduction of an approach which will enable evaluation and promotion of the effectiveness in the process of risk management control and the work.

According to the Rule book for the way of execution of the internal audit and the way of informing for the audit, the internal audit is made of analyses, evaluation giving recommendation, information and advices for the activities which are checked. The aim due to which such audit is made, includes the effective financial management and control with “reasonable” expenses.

The success in internal audit and its contribution in work depends whether it is sufficiently concentrated to the critical risks in the company. That is why it is necessary to see the correspondence of the activities established for management of those risks. It will increase the value of the company as well as the capability successfully to manage the risks that faces. The confirmation and the evaluation of risks mainly will be represented in the evaluation of the necessity of audit by which all aspects of the company will be confirmed and which make part of the overall strategic and annual plan of the internal audit.

The strategic plan must be regularly updated for each made change in the aims, resources and similar. The level and preciseness of details of the plan should be adjusted to the procedures for reaching decision, the necessity of formal approval of the activities and other.

The Section of Interior should secure independent objective persuasion and advice which will help ELS and the subject of public character to fulfill its aims applying systematic disciplined approach for evaluation and improvement of the effectiveness in the processes of risk management and control. It will through the conducted based audits make deep evaluation of the function of the systems of internal control.

The unit of internal audit conducts internal audit in

- Entity of public section
- Individual users
- All structures
- Programs
- Activities and process including those of the users of means of EU funds

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<sup>6</sup> Bozinovska-Lazarevska Z., Audit, Skopje: Faculty of Economics,2001,page 173

- Legal and physical entities that the entity has contacts with business and which use public means

The unit for internal audit in the entity which is liable for the management of the inter resources, programs/projects coordinates the work of the units for internal audit of the entity of the public section which participate in the conducting of the programs /projects.

The unit of internal audit is organizational, functional, independent and directly exclusively liable to the manager of the entity from the public section. The manager of the unit of internal audit is authorized directly to inform the manager of the entity of the public section for all audit issues of the entity of the public section and especially for regularity, effectiveness and efficiency in the conduction of the budget financial plan: including the management with means as well as the coordination with the accounting, reports with accounting standards.

The manager of the unit of internal audit gives an opinion for the internal rules and acts of the entity of the public section regarding the issues connected to the internal financial control and internal audit. It will advise all managers of the entities for the risk management.

Chronological presentation for the existence and application of the internal audit on central and local level for the period between 2006-2012 is presented in the following two charts (chart 1 and chart 2).

**Chart 1 State of the internal audit on central level**

	2006	2007	2008	2009	2010	2011	March	April	May	June	July	August	September	October	November
							2012	2012	2012	2012	2012	2012	2012	2012	2012
Established units of internal audit	24	35	46	58	64	71	72	72	72	72	73	73	73	73	73
Internal auditors	52	68	81	90	111	120	129	130	132	132	133	130	130	130	131
Managers of the units of internal audit	/	/	27	34	34	35	36	37	38	38	38	38	39	42	43
Reports of the internal audit	142	204	222	252	245	241									
Recommendations	1472	1502	1262	1672	1688	1534									
Percentage of the implemented recommendations	39	44	47	54	56	53									

Source: [www.finance.gov.mk](http://www.finance.gov.mk)

**Chart 2 State of the internal audit on local level**

	2006	2007	2008	2009	2010	2011	March 2012	April 2012	May 2012	June 2012	July 2012	August 2012	September 2012	October 2012	November 2012
Established units of internal audit	0	17	32	40	49	59	59	59	60	60	62	62	62	62	63
Internal auditors	15	27	33	35	44	52	53	53	54	54	55	55	55	56	55
Managers of the units of internal audit	/	/	15	18	19	18	18	18	19	19	19	19	20	21	20
Reports of the internal audit	88	107	134	132	172	176									
Recommendations	455	626	707	815	1033	1355									
Percentage of the implemented recommendations	60	68	69	58	72	49									

**Source:** [www.finance.gov.mk](http://www.finance.gov.mk)

From the tabular presentation it can be concluded that the number of established units has been increased for the internal audit, internal auditors as well as preparation of audit reports and giving corresponding recommendation on central and local level and in that way the risks will be put on an acceptable level

The Mayor of ELS will achieve the supervision of the control through continuous activities and corresponding grades. During that surveillance it will be helped by the internal audit of the municipality beside other, it has the obligation to follow the internal control. The Internal auditor has to conduct the following activities: following of the internal checking, examination of the financial and operative information, checking of economic effectiveness and efficiency of the working and checking of the coordination with the laws and internal acts.

The internal audit has to acknowledge the processes which are compositional part of the municipalities in order to identify the important risks that may influence the aims of the financial reporting. It is important for the mayor of the municipality during the audit, the auditor to be able to identify the risks of material incorrect presentation which Mayor did not managed to identify with the process of the risk evaluation for the municipality.

The choice of the audit procedures by the auditor (inspection, surveillance, questioning, analytical procedures) is based on the evaluation of the risks. Larger the evaluation of the audit risk, more

reliable and more relevant will be the audit proofs that will be obtained by the basic procedures.

The using of the audit proofs from the execution of the basic procedures in the given previous audit is not sufficient so that the risk of the material incorrect presentation during the current period to be covered.

The Mayor of the municipality is liable for creation of effective controlled environment. The Internal control enables to secure reasonable security that the municipality:

- Follows the legal regulations and directions
- Promotes economic effective and efficient working
- Preserves the means of unprofessional using and disposal

The constant legal regulation is not sufficient to prevent the appearance of risks in the public section. Due to this, it is necessary to build a system which is made of clear mechanisms and tools for risk management that the municipality is faced with. The internal controls are made of general procedures of the internal control which will be designed in accordance to the standards of internal audit. Basically, the establishment of good system of internal control represents preventative measure for risks, reduction and releasing of the procedure of the internal audit in the municipality.

### **Conclusion**

The internal financial control represents basic and the most important form of control in a public company and the units of the local self government and as such it is equally important for the management and the auditors especially in the achievement of the aims. The concept of the public internal financial control has been developed by the European commission. That concept as well represents a strategy and it has an aim to secure an operational model which will promote the system of internal control primarily in the public section in accordance to the international standards. The system of the internal control which successfully functions helps into direction of the processes and improvement of the level and services quality. It gives reasonable convincing that the aims will be achieved.

The internal audit should secure independent and objective evaluation of the system of the internal control in the entity of the public section. The functional independence of the unit for internal audit is secured through its independence from the other organizational parts of the entity by planning of the work execution of the internal audit and the informing. The success of the internal audit and its contribution to the work depends whether it will concentrate sufficiently to the critical risks in the company. That is why, it is necessary to see the correspondence to the activities established for management of those risks. It will increase the value in the company as well as the capability successfully to manage the risks it faces. The confirmation and the evaluation of the risks will be mainly represented in the evaluation of the necessity for audit by which those aspects of the company will be confirmed which will make a part of the overall strategic and annual plan of the internal audit. That is the point where those plans for the everyday work of the internal audit come from.

The manager of the unit of financial issues at ELS pursuant to the article 11 of the Law of Public Internal Financial Control coordinates the process for preparation and changing and supplementation of the budget and the strategic plan, the process of development, establishment, conduction and maintenance of the financial management and control and the process of accounting, registration for performance of the budget and preparation of the annual account and the annual financial report.

The reaching of the correct approach to the risk management will contribute many important benefits to be achieved by ELS. The strategy for risk management will help the municipalities to fulfill their aims and constantly to promote their way of work and coordination with the standards of EU.

ELS accepts the challenge to conduct the process of the overall management with risks in all areas of working and that will be done in that way that it will not cause critical increasing of the size of the work to the employees. It will be achieved through development of capacities for risk management in the municipalities, but also in public companies and public institutions which will perform activities of public interest. Due to this the risk management will be upgraded in the constant processes and it will not be treated as a special function and it will become a standard approach accepted by all employees at ELS.

In the preparation of the Strategy for risk management at the units of self government or the public business subject it will be started from

the basic necessity: enabling of the management (of the municipality or the public companies) and its employees to have a better view to the future and capability for appropriate conceptualization of own business policy.

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Original scientific paper**

**Efimija DIMOVSKA<sup>\*</sup>)**

**EFFECTIVENESS OF GOVERNMENT PROGRAMS FOR  
IMPROVING THE ACCESS TO FINANCE OF SME'S IN  
MACEDONIA**

**Abstract**

There is wide accepted evidence that the SME sector is one of the most important drivers of the economy in each country. In addition, many studies and research have concluded that access to finance remains to be a major concern and main obstacle for SMEs growth and development in countries like Macedonia. This situation has been deteriorated by the global economic and financial crises.

Therefore, many governments have acknowledged the importance of implementing various policies and programs aimed to support SMEs and their development, particularly in the time of global financial crises. Yet, evaluation and impact assessment of implemented government programs in general is lacking and the effectiveness of such credit schemes has not been demonstrated.

The paper will examine the efficiency of subsidized credit lines implemented by Macedonian Government with a main goal to promote bank lending to SMEs. It will attempt to assess the cost of the Government and the impact on the "supply side" in providing financing for SME sector. The method used for the research is a questionnaire based survey, composed of multiple choice questions and on-site interviews with bank's officials.

**Key words:** access to finance, SMEs, government intervention

**JEL Classification:** G20, G28

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## **1. Introduction**

SME sector is one of the most important drivers of the economy in each country and in different countries they have different financing possibilities, depending on countries' specific characteristics of the financial system and the business environment. The structure of SMEs' financing is depending on both demand and supply side factors. The reasons for a market failure relate to insufficient supply of capital and inadequacies on the demand side. In the presence of market imperfections, any financing limitations will reflect on SMEs' investments. Bank loans are the main source of external financing of SMEs in Macedonia and in many other developing and developed countries. However, there are many factors as higher administrative costs and risks involved in lending to SMEs that reduce banks' willingness to lend to them. Also, lack of collateral and borrower information is frequently reason for credit rejection. Therefore, many governments have acknowledged the importance of implementing various policies and programs aimed to support SMEs and their development, particularly in the time of global financial crises.

## **2. Role and importance of the SMEs**

SMEs play an important role in a country's economy. They are crucial for economic development, particularly in emerging markets. The evidence shows that over 95% of all registered companies across the world are SMEs. This number is even higher in the European Union, where SMEs represent 99, 8% of all businesses, out of which 92, 1% are micro businesses with less than 10 employees. (Wymenga, Spanikova, Derbyshire, Barker, 2011: p.9)

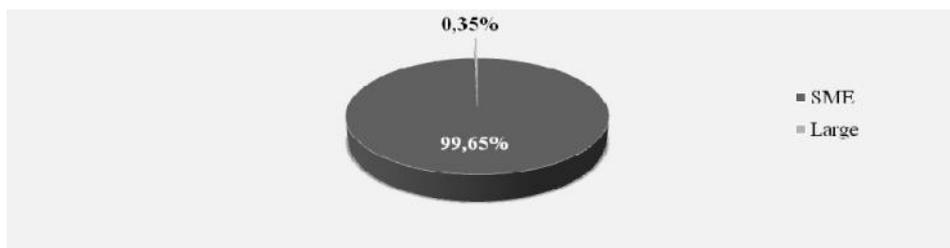
SME sector makes a critical contribution to GDP and employment in both developed and developing countries. In terms of employment, 67% of all job places in the European private sector are within the SME sector. European Commission has published a study regarding the SME role in creation of new job places. (Kok, Vroonhof, Verhoeven, Timmermans, Kwaak, Snijders, Zoetermeer, 2011) The results of the analysis shows that in the period 2002-2010, 85% of the newly created jobs were in the SME sector, which is a higher figure comparing to the a.m. SMEs share of 67% of all jobs in EU. Regarding

the SME contribution to the GDP creation, their importance is not lesser, achieving nearly 60%.

The position of the SME sector in the Republic of Macedonia is similar to EU. Namely, the data from the Central Register of the Republic of Macedonia for the period 2006-2012 show continuous enlargement of the officially registered enterprises. The classification by size of enterprises in the Republic of Macedonia is regulated with the Company Law, according to the number of employees, annual turnover and total assets. (Official Journal of the RM, 2004)

The biggest part of the active enterprises in the Republic of Macedonia, or 99, 65%, is the SMEs<sup>1</sup>.

**Figure 1. Structure by size of active companies in Republic of Macedonia in 2012**



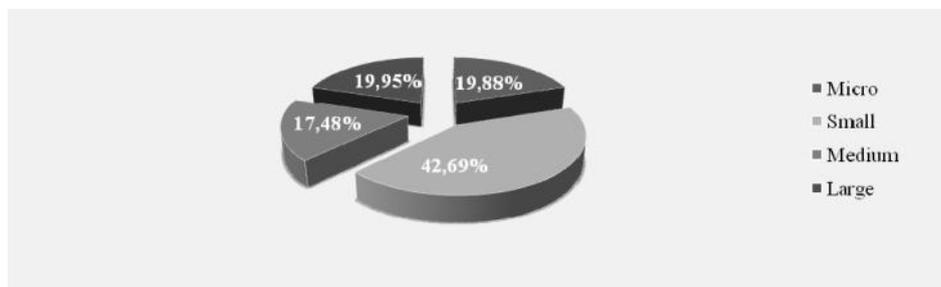
Source: Central Register of the RM, 2013

SME sector in Macedonia participate with 80, 5% of total employments, while 19, 5% of employments are in the big companies. These data provide evidence of the SMEs importance for the entire economy. Contribution of SMEs to the creation of the GDP in Macedonia in 2010 is around 64% (State Statistic Office, 2012).

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<sup>1</sup> SMEs refers to micro, small and medium enterprises

**Figure 2. Share of employments by company size in 2012**



Source: Central Register of the Republic of Macedonia, 2013

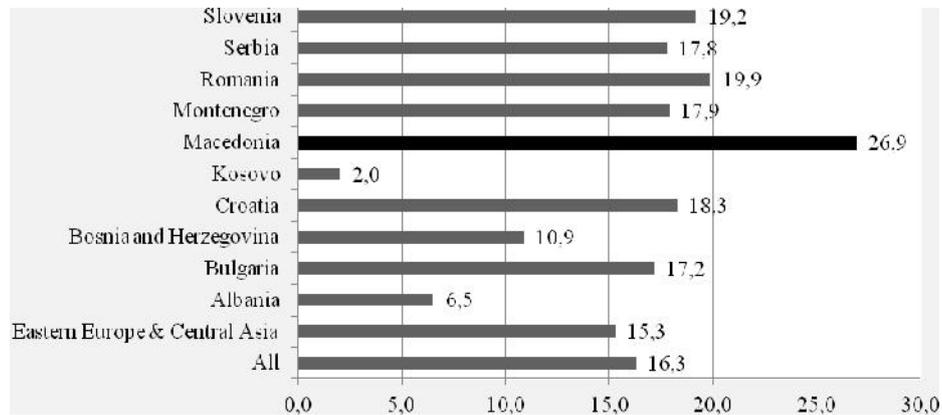
### **3. Access to finance: is there a problem?**

Despite the importance of SMEs for the economic growth and jobs creation, their formation, survival and development is often troubled by several obstacles. Various researches around the developing world provide evidence that SMEs face greater financing obstacles than large firms. (Beck, Demirgüç-Kunt & Maksimovic 2005; Beck & Demirgüç-Kunt 2006; and Beck, Demirgüç-Kunt, Laeven, Maksimovic 2006)

World Bank, in cooperation with the EBRD, in 2010 has conducted a detail survey called Business Environment and Enterprise Performance Survey – BEEPS. The survey was made on a representative sample of enterprises through direct interviews. One of the topics covered in the survey include obstacles for doing business. (World Bank, 2010)

According to this survey, 26,9% of the interviewed Macedonian firms identified access to finance as their major obstacle for doing business, which is the second ranked obstacle, after informal economy.

**Figure 3. Percentage of firms that identified access to finance as the biggest obstacle for their operation**



Source: Business Environment and Enterprise Performance Surveys-BEEPS, 2010

The general results of this survey confirm the financing obstacles for Macedonian SMEs and it can be concluded that Macedonian enterprise have bigger financial problems, comparing to the other analyzed countries. It must be noted that this obstacles are intensified with the world economic and financial crises.

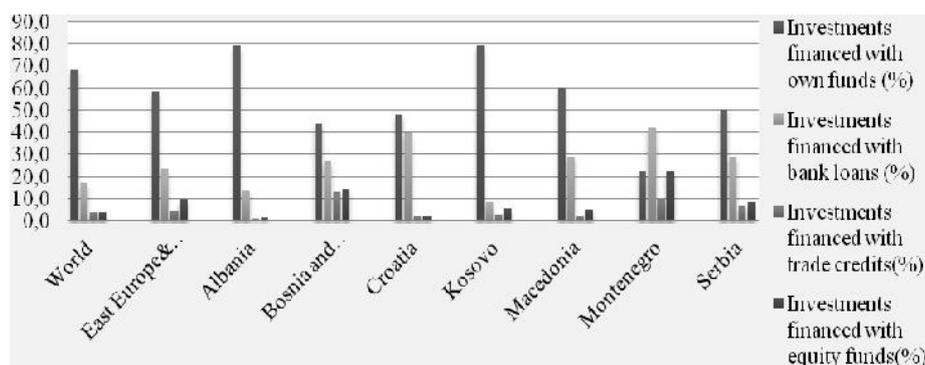
#### 4. Sources of financing

External sources of financing are critical component for the enterprise growth. Different analysis conducted in the Western Balkan countries demonstrates the domination of the banking sector comparing to other external sources.

The analysis carried out by World Bank, in cooperation with EBRD, (World Bank, 2010) shows that the most frequently used source for the planned investments of SMEs in Western Balkan countries are internal funds (71, 8%). As a second source are banking loans (15, 4%), while the percentage of investments financed by equity funds, leasing and other alternative sources of financing is very low, comparing to the developed market economies. This survey shows that bank loans represent 40% to nearly 80% of external funds obtained by SMEs in

SEE. This situation is mainly due to the growing banking sector in the past several years and undeveloped capital markets and equity finance.

**Figure 4: Structure of financing sources (%)**



Source: BEEPS, 2010

Therefore, the further analysis concerning the financing issue of SMEs should be focused on banking sector. However, there are many factors that reduce banks' willingness to lend to SMEs. The economic literature on enterprise financing has identified few main reasons why banks are often reluctant and avoid lending to an SME: (Zavatta, 2008)

1. The information asymmetry that exists between small businesses and lenders, or outside investors i.e. lack of relevant financial information, credit history etc.
2. The high risks involved in lending to the SME, associated with small scale activities, high failure rates, low capitalization and exposure to market risks, because they operate in a more competitive environment.
3. The high transaction costs in administrating SME loans.
4. The lack of collateral that usually characterizes SMEs, which may have little or no assets that can be used as collateral.
5. The lack of bank's capacity and skills to conduct a credit determine whether the borrower possesses the technical, managerial and marketing skills to generate adequate cash.

In developing countries, such as Macedonia, these problems are often worsened by institutional factors, such weak creditors' rights and protection, weak judicial system and bankruptcy procedures, lack of information infrastructure, etc.

## **5. Role of the Government**

The question is whether the Government should undertake measures to mitigate the problem that SMEs are facing in obtaining finances for their activities? In the economic literature there are different theories and opinions. (See Stiglitz, 1994; Klapper and Zaidi, 2005) Public intervention may be considered justified where market is failing to provide the required financing necessary for the less-favoured sectors, regions or clients. In addition intervention by the public authorities is needed to mitigate the effects from certain external shocks, i.e. to assist a certain sector affected by this negative impact. As already mentioned, there is market imperfection due to which Macedonian SMEs have problems in access to finance. Furthermore, the world economic and financial crisis from 2008 is certainly that kind of external shock, causing negative effects to the Macedonian SMEs. This gives good reason for the Government to intervene.

The other question is what form such intervention should take: interest-rate subsidies, guarantees, loans, equity financing or something different?

## **6. Macedonian case: EIB credit line**

As a response to the economic and financial crises the Government of the Republic of Macedonia in 2009 has decided to apply for a loan from the European Investment Bank to increase the available capital for Macedonian companies, and to mitigate the negative effects of the crisis in the Macedonian banking sector. EIB has provided similar loans for SMEs and priority projects in other SEE countries: Croatia, Serbia, Montenegro, Bosnia and Herzegovina, Turkey and Albania. In the time of crisis banks have become even more conservative in loan approval, which worsens already difficult financial situation of the SME sector.

The Financing Agreement for SME credit line in amount of 100 million EUR was signed between Macedonian Bank for Development Promotion - MBDP and EIB. MBDP is the only development state-owned bank in the RM, established in 1998 under the specific Law on establishment of MBDP (Official Journal 24/98, 6/2000, 109/2005, 130/2008, 105/2009), with main mission to provide financing support to SMEs and to support national economic strategies and objectives.

The credit line was disbursed through intermediary banks, contracted by MBDP, which has onlended the funds to the final beneficiaries. The total amount of the credit line was fully disbursed by April 2011. (MBDP, 2011)

The credit conditions applied for the final beneficiaries have been changed several times since the project start-up, meeting their demands, yet in line with EIB requirements. The final criteria were as follows:

- 100% financing by the EIB funds for SMEs and co-financing up to 50% in partnership with the local commercial banks for priority projects.
- Interest rate of 5, 5% p.a. for the final beneficiaries.
- Purpose: investments, permanent working capital and priority projects
- Target group: SME's and all registered enterprises under the Law on trade companies for the priority projects only.
- Maximum amount of 3, 5 million EUR per loan for SMEs and 12, 5 million EUR per loan for priority projects.
- Repayment period up to 5 years for investment loans, up to 3 years for loans for permanent working capital and up to 15 years for priority projects, with grace period from 6 to 12 months.
- Collateral is defined by each participating bank, according to their credit policy.

It must be noted that despite the favorable credit conditions, EIB loans are commercially approved loans to beneficiaries with good credit history and good cash flow that ensures timely repayment of the installments.

This credit line was withdrawn earlier than projected due to the big demand of the SME sector for the EIB loans. The following table presents the structure of the EIB credit line portfolio by three characteristic: target group, purpose and sector.

**Table 1: Portfolio structure**

	Number of financed projects (%)	Disbursed amount (%)
<b>By target group</b>		
<i>SMEs</i>	97	89
<i>Big enterprises</i>	3	11
<b>By loan purpose</b>		
<i>Investment loans</i>	N/A	24
<i>Permanent working capital</i>	N/A	57
<i>Priority projects</i>	3	19
<b>By sectors</b>		
<i>Production</i>	53	61
<i>Construction</i>	8	7
<i>Trade</i>	23	18
<i>Transport</i>	2	3
<i>Health</i>	6	4
<i>Hotels/Restaurants</i>	6	2
<i>Other</i>	4	6

Source: MBDP, 2011

The structure of the EIB loan portfolio in terms of the loan purpose shows that 57% of the disbursed amount is for working capital, which reflects the situation in the Macedonian economy. As a result of the economic crisis SMEs in Macedonia are facing a big problem with their liquidity. Regarding the structure by sector, the biggest percent of the funds (61%) were invested in production companies.

The total number of financed project with the EIB100 million EUR credit line is 306, out of which 97% are SMEs projects, and only 3% are for big companies. According to the MBDP data, collected from the final beneficiaries, this credit line has supported creation/retention of 2.140 jobs.

The EIB credit line represents a model of indirect interest rate subsidies on commercial loans extended to SMEs. The interest rate subsidy is technically realized by providing funds to commercial banks at low rates and these low rates are then passed on to SMEs through lower interest rates on the commercial loans approved by these banks.

For the funds onlended to intermediary banks MBDP is charging 1% p.a. on outstanding balance. As described above, the intention of the

Government with this credit line was to provide additional credit funds under favorable conditions for the final beneficiaries. Therefore, in the agreements signed between MBDP and intermediary banks the interest rate for the borrowers is fixed at 5, 5% p.a.

Subsequent to the fast disbursement of this credit instrument, and deepening the problems of the SMEs as a result of the on-going crisis in the Euro zone, EIB has approved two additional credit lines to Macedonia, one in October 2011 in amount of 50 million EUR and the second in July 2012 in amount of 100 million EUR. (EIB, 2012) The criteria are very similar to the first EIB credit line, and the only significant change is the increase of the repayment period for the investment loans to 8 years with 2 years of grace period, and for the working capital to 3 years with 6 month of grace period. (MBDP, 2012)

## **7. Research**

### **➤ Impact evaluation**

In order to explore the supply side factors i.e. banks' experience and policies in lending to SMEs and to evaluate the impact of the EIB 100 million credit line on participating banks, a survey was carried out on five banks that are contracted by MBDP for servicing the EIB credit line. The selected sample represents 31% of the whole population (16 banks) and they account for about 70% of total assets in the banking sector in Macedonia and 82, 6% of the total EIB portfolio. Three out of five banks are large, and two are in the group of middle banks. Four of five banks are with majority of foreign owned capital. The survey was conducted in the period July – September 2012 using a questionnaire of multiple choice questions that was sent by e-mail to responsible managers for SMEs lending in the respective bank. The questionnaire was organized in three main groups of questions:

- Main information regarding SME lending;
- Potential and obstacles for SME lending in normal conditions and in the time of crisis;
- Role and intervention of the Government and their effectiveness.

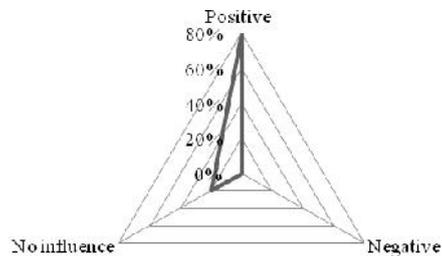
One of the goals of the research was to determine the impact on the bank's SME lending as a result of the cooperation with MBDP. The purpose was to conduct simple evaluation of the EIB 100 million credit line, which is a main source of SME financing through MBDP. Surveyed

banks participated with 82, 6% of the total EIB portfolio and represent a sample with significant relevance. The impact evaluation was performed from three different aspects. The general conclusion is that participation in MBDP credit lines has positive influence on bank's SME lending.

*a) Impact on total SME credit portfolio*

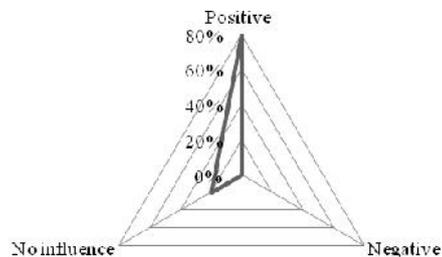
The results from the survey show significant positive impact on the total SME credit portfolio.

Four or 80% of the banks stated that as a result of the cooperation with MBDP their SME credit portfolio has increased by 4%. Only one bank answered that the cooperation with MBDO does not have influence on its SME credit portfolio.



*b) Impact on SME interest to apply for a loan*

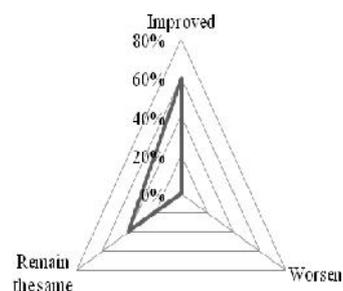
The results are the same as in the previous question i.e. four of the banks or 80% emphasized that based on the cooperation with MBDP the number of SME's credit applications has increased by 10%. Only one bank has stated that there is no influence.



*c) Impact on credit conditions (interest rate, repayment period and collateral)*

Regarding the credit condition the general influence is positive. Three or 60% of the banks answered that based on the cooperation with MBDP, the SME credit conditions, despite of the source of funding, has improved. Two of the banks answered that there is no influence.

In this part of the analysis it must be taken in consideration that the EIB credit conditions are defined in advance, within the Financing Agreement between EIB and MBDP or in the Subsidiary Loan Agreement between MBDP and the relevant bank.



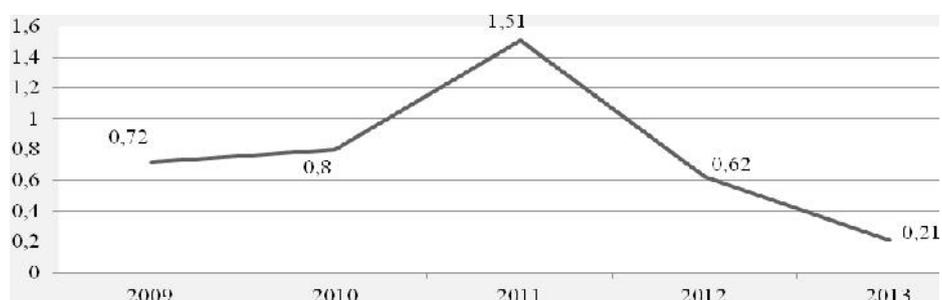
➤ Budget cost assessment

MBDP is obliged to repay the loan to EIB using flexible interest rate based on 3-months Euribor under the Financing Agreement and calculated on the outstanding balance of each tranche. The likely mismatch of the earned interest from the banks and due repayment obligation to the EIB is financed with Government budget funds.

The full loan amount was withdrawn in nine tranches starting in December 2009, and the last tranche was withdrawn in April 2011. For six tranches variable interest rate is applied based on the 3-month Euribor for the appropriate period increased for 50 basis points. As shown in the graph bellow, the Euribor rate for the analyzed period is in the interval from 0,21% to 1,51%.<sup>2</sup>

<sup>2</sup> For 2009 the average rate is for December, for 2010, 2011, 2012 the average is calculated on yearly basis, and for the 2013 the average is for January and February

**Figure 5: Average 3-month Euribor rates for the period December 2009 – February 2013 (%)**



Source: <http://www.euribor-rates.eu/>

The average 3-month Euribor rate for the analyzed period is 0,77%, and increased by 50 basis points, the price for the EIB tranches withdrawn under variable rate is 1,27%. On the remaining three tranches, the interest rate is in average of 2%. The weighted interest rate for all nine tranches is 1,5%, which is not significantly higher comparing to the 1% charged to the participating banks. The budget cost or the indirect subsidy can be determined as a variance between the interest incomes and expenditures of MBDP for the EIB credit line. Bellow, a hypothetical calculation of the Government cost is presented for the first three years of the loan, which is still in grace period.

**Table 2: Calculation of the Government subsidy for the EIB 100 millions credit line for the period 2010-2012 (in EUR)**

Year	Withdrawn amount	Interest income (1%)	Interest expenditures (1,5%)	Variance (Government subsidy)
2010	70.000.000	700.000	1.050.000	350.000
2011	100.000.000	1.000.000	1.500.000	500.000
2012	100.000.000	1.000.000	1.500.000	500.000
Total interest subsidy for 3 years				1.350.000

Source: own calculations

If such calculation is applied for the entire repayment period, the projected total amount of budget costs is app.4 million EUR, allocated over 15 years.

## **8. Conclusion**

Appropriate, tailor made, commercially driven public measures in place will help to mitigate the market imperfections and weaknesses in SMEs' access to finance not only in times of crisis but on an on-going basis as a fundamental structural issue. Design of subsidized financial products, targeting strategic sectors, should be considered as one of the solutions to overcome the problems in obtaining necessary finance. Indirect interest subsidies do not violate the WTO Agreement on Subsidies and Countervailing Measures and they are classified as a voluntary compromise by the participating banks in order to expand their outreach. Furthermore, the indirect approach of interest rate subsidy eliminates the negative effects from such Government intervention, in terms of inefficient and nontransparent funds allocation.

Another advantage, which is of great importance, is the low cost for the Government for implementation of such onlending activities. Even if the reference rate for calculating the interest (Euribor) increases, still the budget participation is not going to increase significantly. While initially offering incentives to participating financial institutions to expand their SME lending, the long-term objective of these interventions should be that banks would increasingly start to consider SMEs as part of their mainstream clientele that would in the future be served wholly with the banks' own recourses.

Through the financed investment 2.140 job places are created or retained. If we take the minimal gross and net salary in the Republic of Macedonia<sup>3</sup> as a base for calculation, in that case the monthly inflow in the Government budget from taxes and contributions is in average amount of 4.200 MKD per worker. Consequently, the annual amount for all 2.000 jobs will be approximately 100, 8 million MKD or around 1, 6 million EUR. This indicate that the Government subsidy cost will be repaid in the in budget for very short period of time. In addition the

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<sup>3</sup> Minimal gross sallary in RM is 12.265 MKD, and the minimal net sallary is 8.050 MKD

reduction of unemployment, due to the new jobs creation, influences the decrease of the budget costs for social transfers.

Regarding the effect on the economy, the assumption is that the total value of the financed projects is higher than 100 million EUR, taking in consideration the participation of the borrower of at least 20% of the project costs. From the repayments of disbursed loans MBDP builds a revolving fund that is used for financing of new loans for the target group. This implies multiple economic effects of the credit line

The performed impact evaluation on the “supply-side”, regarding the participation of the banks in the MBDP credit lines, indicates positive influence on bank’s SME lending (total SME credit portfolio, credit conditions, SME interest to apply for a loan). In order to complete the impact assessment, monitoring on the loan quality should be established by MBDP/Government and comprehensive survey on beneficiaries should be conducted to evaluate the effects of the EIB loan on their

However, it must be noted that the total loan amount disbursed through MBDP, as one of the main Government support instruments, is considerably smaller comparing to the total net credits approved to private sector as of 31.12.2011. Namely, the share of the MBDP net credit portfolio in the total banking sector portfolio at the end of 2011 is only 4%. Moreover with the first EIB 100 million credit line MBDP has onlended only 306 loans to SMEs which is 0,4% of active SMEs in Macedonia. This data point to certain situation that needs to be further closely reviewed.

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**Professional paper**

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**Diana BOSKOVSKA<sup>\*\*)</sup>**

## **FACTORS INFLUENCING SCIENTIFIC MIGRATION-CASE OF THE REPUBLIC OF MACEDONIA**

### **Abstract**

Republic of Macedonia as developing country, in order to provide sustainable economic development, naturally needs to straighten its human resources. In these sense, it is of immanent importance to ensure adequate use of all created knowledge in the country.

Contrary to this, latest data show that Republic of Macedonia is faced with highly intensive scientific emigration. In this context, this paper is observing the main factors influencing the scientific migration, in general and with special emphasis to the Republic of Macedonia. Main objective of this paper is to present and analyses current situation regarding tertiary education and research and development sector in Republic of Macedonia. Namely, in the focus of this paper are high production of graduates and postgraduates, unfavorable sources and structure of founding and employment, as well as low expenditures for development of the research and development sector in the Republic of Macedonia. One of the intentions is to make an attempt to answer the question if Macedonia is using efficiently the produced knowledge. Based on the analysis and examination of the crucial determinants, expected outcome is to identify causes of the remarkable trend of scientific migration and to give appropriate recommendations for overcoming this situation.

**Key words:** knowledge, sustainable economic development, scientific migration, research and development

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**JEL classification number: F66, J2, J6**

### **Introduction**

Knowledge is essential for individual progress and development of the national economy as well as its integration into global trends and is a key factor for achieving sustainable economic development in the long term. The effective use of knowledge depends on the extent to which a national economy can reach previously specified order, which emphasizes the inseparable link between the economic and the educational system.

Countries that have achieved outflow of human capital, suffered multiple significant adverse effects (slowing of economic development and the development of science, reduced productivity and competitiveness of the country and so on.). "Brain Drain" not only adversely affects the available stock of human capital in a given country, but creates other unfavorable effects on the broader socio-economic system.

When it comes to Macedonia in mind that we are still in the phase of "brain drain" from the country, the effects generated by this process is negative, leading to reduced production base of the country, slowing the development of science and research, slowing the technological development of the country, based on the reduction of the available human capital from one side, and less application of transfer of technology and knowledge from abroad from other side.

Macedonia is faced with the need to produce a quality of highly educated, or science- research staff, but as creators and disseminators of knowledge. This means that it is not enough only its production but it's effectively using in the function of sustainable economic development. Unlike developed countries where knowledge applied in the business sector, in the Republic of Macedonia it is usually associated with universities (academia) and public administration.

In science are analyzed a number of theoretical and empirical aspects of scientific migration, whereas particularly interesting ones of the periods before and after the fall of the Iron Curtain. Most theoretical approaches for analyzing scientific diaspora mainly based on general theories of migration, the prevailing view that is not entirely appropriate because failed to fully explain the phenomenon. In many of them

exaggerated the economic aspect, and less attention is paid to the analysis of other factors that cause mobility. Other theoretical concepts the mobility of highly educated and scientific research personnel explain in the context of globalization, the emergence of multinational companies and intermediary agencies that facilitate the movement of human capital. In such concepts the globalization clue as mutual interconnection of the world, and the migration is interpreted as a form of creating networks. Here the driving force is economic and educational compatibility, which explains the Americanization of education systems in Europe, particularly in post-socialist countries of Central and Southeast Europe.

### **1. Types of mobility of the highly educated and scientific research staff**

Observed historical mobility of the highly educated and scientific research personnel, passes through several stages. Despite the general migration, the occurrence and trends are continuously monitored; interest in the scientific community for research mobility highly educated staff is relatively recent. The first findings of monitoring the occurrence of the general public and are presented in 1963, when he introduced the term "brain drain". Scientific debates in that period have been caused by the alarming outflow of British highly educated and research staff in the U.S. Then commenced intensive debate continues to this day, resulting in the expansion and differentiation of the terminology used to explain the mobility of scientists. Thus, the "brain drain" is considered permanent migration of scientists from poorer to richer countries, whereas positive effects a country that takes such personnel, while the country that broadcast has negative effects.

As a clarification of the term "brain drain" in the early 90s of last century, the scientific debates introduces the term "brain exchange", which explains the spatial exchange (spatial displacement) knowledge that primarily occurs between developed countries. This term denotes balanced exchange highly educated and research staff. If the ultimate effect of such exchange is unidirectional negative for the country that broadcast staff, then it is a "brain drain", but if the effect is unidirectional

positive for the country that receives them, then more precise definition of emergence uses the term "brain gain." <sup>1</sup>

Another mechanical term which is used to explain the scientific mobility is the term "overflow the brain." It occurs when a given country is excessively produced highly educated and research staff, the domestic labor market has the capacity to absorb. Consequently, highly educated and scientific research personnel are forced to leave the country. The late 70s and early 80s of last century, "overflow the brain" was a term that has been interpreted mass emergence of scientific diaspora of POS-socialist countries in Central and Southeast Europe. In fact, the former level of competitiveness of their economies, most former socialist countries had oversized research sectors. By changing the economic system and the liberalization of the higher education and science sector in these countries occurred simultaneously transfer the staff to the private higher education and science institutions or business sector, or so-called "internal brain drain" and migration in developed countries, or "brain drain". <sup>2</sup>

In the late 80s of last century, introduced the term "brain circulation" which is used to explain the trend of returning emigrated highly educated and academia staff, which appeared in North Korea and India<sup>3</sup>. Also, the "brain circulation" became the preferred form of scientific mobility because the probability of dispersal and circulation of knowledge is greatest. Another term that clarifies the emergence of mobility of highly educated and research personnel, especially in post-socialist countries, is the so-called "horizontal outflow of brains." This form of mobility occurs when individuals occupied with scientific research, mostly due to low salaries and poor working conditions, they leaving scientific activity and moving into the business sector. Result of "horizontal drain brain" is the emergence of "brain waste", and accepts the jobs and tasks that do not require knowledge, skills and experience acquired in the process of education or previous employment. Depending on whether people leave the research activity will remain in the country or emigrate, "waste of brains" will be internally or externally. As a lighter form of "brain waste" is considered the emergence of "brain

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<sup>1</sup> Devesh Kapur and John McHale, *The Global Migration of Talent: What Does it Mean for Developing Countries?*, Centar for Global Development, October, 2005, p.17.

<sup>2</sup> Andreas Breinbauer: *Brain Drain-Brain Circulation or...What Else Happens or Should Happen to the Brains Some Aspects of Qualified Person Mobility/Migration*, FIW Working Paper N°4 June, 2007, p. 2.

<sup>3</sup> Danny M. Leipziger: "Brain Drain" and the Global Mobility of High-Skilled Talent, World bank, Prim Notes, No. 124, September, 2008.

freeze" in which regardless of whether you leave scientific research or not, highly educated and scientific researchers do not use the maximum of their capabilities and qualifications or at least not to the extent to which they would like.<sup>4</sup>

The previous terms confirm complexity and uniqueness of physical displacement of scientific research personnel and the need of clarification. Namely, within the global scientific community, physical displacement and interaction between scientific researches is basic purpose of the production and transfer of knowledge, and in this respect, migration is only one kind of scientific mobility. Additionally, in the 21st century, study visits to foreign institutions have become an essential prerequisite for advancement in scientific research career.

## **2. Factors affecting the mobility of scientific research staff**

The mobility of highly educated personnel affects factors such as:<sup>5</sup>

1. Differences in the amount of wages or earnings of Individuals between different national economies. This factor is closely correlated with the level of development of a given country, so that the difference between the levels of economic development of individual countries requires the size and mobility of highly educated staff. Differences in economic development between the countries primarily relates to differences in rates of economic growth, which in turn leads to the existence of differences in 'income per capita and living standards. In this context, from the international point of view, the mobility of individuals takes place from poorer, less developed countries in richer, more developed economies.

2. Factors immaterial. In addition to salary or earnings, a very important factor especially for scientific profile of staff present intangible factors that influence the decision to leave own countries and resettlement in other countries. These intangible factors primarily related to the opportunity to work in prestigious universities, research centers, and developed research infrastructure in countries that allocate large amounts of funding for science and research and so on.

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<sup>4</sup> Andreas Breinbauer: Brain Drain-Brain Circulation or...What Else Happens or Should Happen to the Brains Some Aspects of Qualified Person Mobility/Migration, FIW Working Paper N°4 June, 2007, p. 8.

<sup>5</sup> Solimano A.: Cause and Consequences of the talent mobility, Oxford University Press, 2008, str.5.

3. Demand for factors of production. This factor is closely associated with the development of economic opportunities and living conditions in a given country. Because mutual correlation of factors of production, economic development opportunities are bigger (have higher growth rate) and at the same time becoming more attractive for foreign capital, influx of foreign labor and human capital. Moreover, these countries the human capital need can provide a number of ways:

- The human capital to provide through permanent employment of highly educated staff available on the domestic labor market;
- Outsourcing contracting, whereby it possible to use domestic and / or foreign human resources;
- Re-allocation of capacities in countries where you can use human capital or knowledge at a lower price.

4. Level of technological development of countries. This mainly refers to ICT, which in the modern economy clearly facilitate the mobility of factors of production, including knowledge. The attraction of highly educated and scientific staff is causally related to the high level of technological development. Indeed, ICT has enabled the development of outsourcing, i.e. satisfying the needs of human capital and knowledge, without their physical migration.

5. Effect of agglomeration and concentration. The emergence of modern and developed centers-agglomerates, in which a concentration of renowned intellectuals from various fields, creating interest and motivation to be in the middle of the action. This is particularly evident in the migration of scientists and researchers because it allows them to cooperate, and it is important for them to share knowledge and experiences with reputable and quality personnel.

6. Socio-cultural and linguistic affinities. In the modern era language and socio-cultural differences between different countries are less constraining factors for mobility of individuals, particularly for highly educated staff. Long positive trend of foreign languages, coupled with the impact of pervasive globalization has led to a reduction of language barriers and raising the overall socio-cultural awareness. In terms of scientific migration, this has led to the emergence of so-called international elite that has gained education on the prestigious education faculties in the world and is part of the alumni networks of other prestigious research, highly educated and professional institutions. This in turn allows greater mobility of knowledge.

7. Political regime and migration policies of countries. Macroeconomic stability, political environment, administrative efficiency and the level of investment in science, are important factors in migration flows. Understandably, there also should be especially emphasized the role of migration policies of the states as they have a direct impact on mobility, inflow and / or outflow of human capital. In modern times, the need for knowledge in all countries, increasingly intensifying their mutual competition and struggle in attracting highly educated staff. Thanks to the application of various concepts, developed countries increase their own attractiveness in the function of continuous knowledge transfer. On the other hand, the developing and poor economies introduced policies that endeavor to reduce the outflow of highly educated staff or possibly attract staff from other countries, in order to compensate the internal lack of highly educated staff or research staff.

### **3. Main determinants of scientific migration in Southeast Europe and the Republic of Macedonia**

Taking into consideration World's Bank latest data for the period 1997-2005, the emigration rate of Macedonian highly educated persons was more than 29%,<sup>6</sup> that is highest emigration rate in the group of candidate countries for full-flagged membership into EU. This data impose immanent importance to analyze main determinants of scientific migration in Southeast Europe and the Republic of Macedonia.

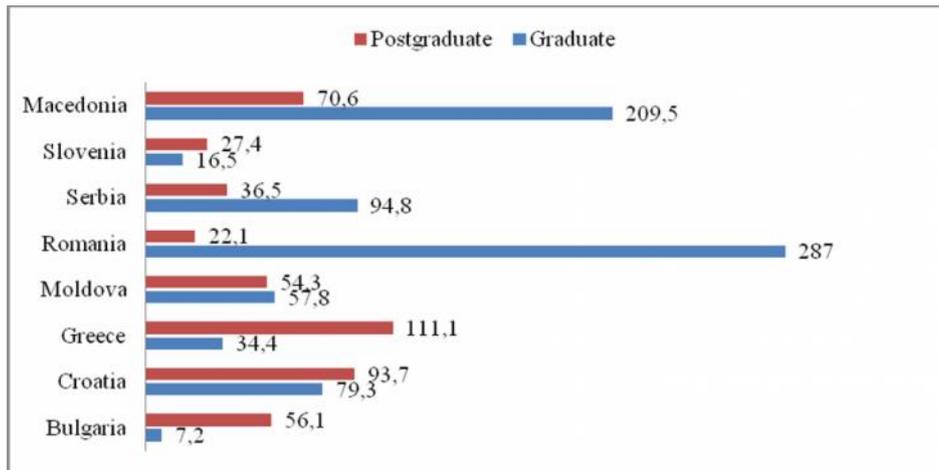
This section presents analysis in terms of the several of determinants contributing to this alarming emigration and comparisons are made regarding the trend of creating a high-educated staff, the structure of funding sources and sectors employing scientific and research staff. Namely, as in all countries in the region, the reform process in higher education Macedonia started immediately after independence and in early 2000 resulted in the establishment of private higher education institutions. The emergence of private higher education institutions increased the possibility of studying for a large number of citizens, and thus from year to year there is permanent increasing in the

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<sup>6</sup> Trading Economics.com:<http://www.tradingeconomics.com/macedonia/emigration-rate-of-tertiary-educated-percent-of-total-tertiary-educated-population-wb-data.html>

number of graduates and master's degree students, as can be observed from Chart 1.

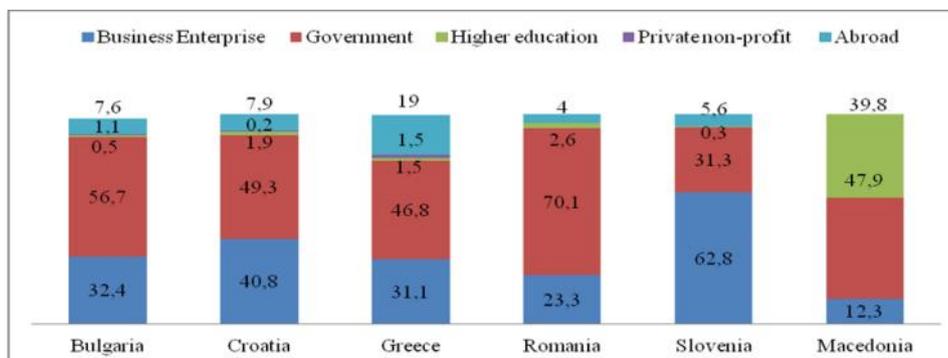
**Chart 1. Growth in graduate and master's degree students in Southeast Europe, in the period 2002-2008, in %.**



Source: UNESCO Science Report 2010, p. 188

From the data presented in the Chart 1., it can be clearly seen that this trend is typical for other transitional economies. Regarding the sources of the funds spent on research and development, it should be said that in the case of Republic of Macedonia there is a deviation both in the number, and the structure of the sources (Chart 2.). Namely, in Macedonia, compared with other countries from the region, private nonprofit institutions and foreign resources, do not appear as a founding source. Regarding the structure, it can be said that there is no significant concessions in terms of expenditure made for research and development from the national budget, as opposed to expenditures made in this respect by the entities in higher education (39.8%) and business sector (12.3%).

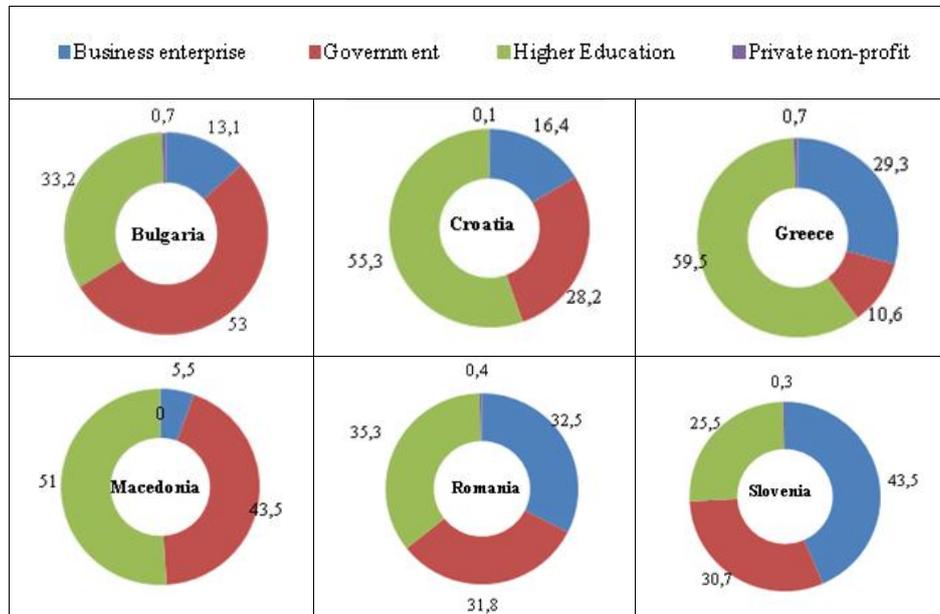
**Chart 2. Structure of sources of Funds to fund research and development in Southeast Europe, in 2008, in %.**



Source: UNESCO Science Report 2010, p. 187

From Chart 3., it is clear that the Macedonian scientific researchers are mostly engaged in higher education (51%) and public institutions (43.5%), and much less in the business sector (5.5%). A similar structure of employment is present in other countries in the region. Only exception is Slovenia, where the business sector is in the same time biggest funder of research and development (62.8%), and the sector in which most scientific research staff is engaged (43.5%).

**Chart 3. Structure of sectors that employ scientific research staff in Southeast Europe, in 2008, in %.**



Source: UNESCO Science Report 2010, p. 189

For the Republic of Macedonia, it should be pointed out that there is low level of investment in this sector, as confirmed by the data presented in Table 1, where it is given a comparison with EU-27, which only supports the previously stated conclusion. An additional concern is the negative trend of the share of expenditure for research and development in GDP of Macedonia, despite the positive trend in the EU27 Member States.

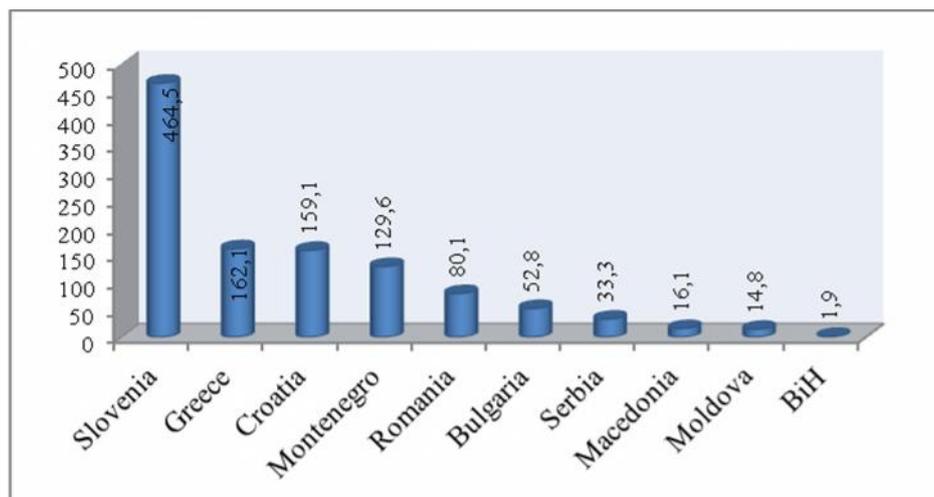
**Table 1. Participation expenses for research and development of the total GDP in the Republic of Macedonia for the period 2001-2009, in %.**

	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b>Republic of Macedonia</b>	0,20	0,19	0,20	0,17	0,16	0,17	0,16	0,14	0,11
<b>EU 27</b>	1,86	1,87	1,86	1,83	1,82	1,85	1,85	1,92	2,01

Source: State Statistical Office, Eurostat

Regarding the same parameter, the Republic of Macedonia is also lagging in comparison with other countries in Southeast Europe, as can be seen from Chart 4.

**Chart 4. Gross expenditure on research and development in South East Euro, in 2007, in U.S. dollars**



Source: UNESCO Science Report 2010, p. 186

As shown in Chart 4., in 2007 in Macedonia, in the sector of research and development have been invested 16.1\$ per capita, which is nearly 29 times less than funds that for the same purpose designated in Slovenia.

## Conclusion

From the analysis in the paper, it can be concluded that Macedonia is still in the phase of "brain drain" from the country, resulting in numerous adverse effects, leading to:

- Reducing the production base of the country;
- Slowing the development of science and research;
- Slowing the technological development of the country, on the basis of reduction of the available human capital, as well as insufficient application of transfer of technology and knowledge from abroad;

- Reducing the level of productivity of the economy, given that the lost human capital is with high capital productivity, and in the same time is the resource that can increase the productivity of labor and capital;
- Reduction of living standards;
- Reduction or weakening of the international competitiveness of the country;
- Reduction in tax revenues generated from tax revenues that are created on the basis of human capital and other.

Regarding the findings concerning the analysis of the factors for emigration of highly educated staff, and the trend of its production and use, with particular reference to the situation in the research and development activities in the country, situation is unfavorable. Namely, there is permanent positive trend in creation of highly educated staff that simply cannot be absorbed in the economy, including the development and research sector. As a result, much of the staff remains unemployed or gets engaged in activities where the knowledge gained in the educational process is not required, and thereby not used, or as a last resort, left the country.

Specifically for the Republic of Macedonia, it can also be concluded that research and development activities are mostly financed by the state budget, and that public sector is the biggest employer highly educated staff.

Also, mostly as a result of its low profitability and inability to allocate more funds, the role of the Macedonian business sector is supporting the research and development in the country is insignificant.

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Professional paper**

**Kimo CAVDAR\* )**

**SIMILARITIES AND DIFFERENCES OF ASSOCIATION AS  
PARTNERSHIPS, COOPERATIVES, PUBLIC TRADE  
COMPANIES AND COMPANIES WITH LIMITED LIABILITY**

**Abstract**

In this study the author elaborates similarities and differences of association as partnerships, cooperatives, public trade companies and companies with limited liability considering the needs and target the partners within any of those types of associating would like to achieve. Thereby those similarities and differences are analyzed from the aspect of: way of establishing and persons establishing the company, property of the company, bodies making decisions at the company, management and the representation of the company as well as the liabilities of the partners for Company's obligations toward third entities. In this process of recognition of those differences it is considered that the partnership as association is not a legal entity and is regulated by the Law on Obligations, while the cooperative as legal entity is regulated by the Law for Cooperatives, while the Public Trade Company and the Company with Limited Liability as legal entities are regulated by the Law for Trade Companies, so the analysis is focused on regulations of each of those laws for the purposes of elaboration of aspects designated in this study.

At the end of elaboration is concluded that the complexity of relations created in relation with and because of each of those associations inquires partners thoroughly to survey all implications that may appear from association form they will decide for, considering the specific circumstances and environment wherein the business activities in Republic of Macedonia are taking part.

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**Key words:** Company with limited liability, Cooperative, Public Trade Company, Partnership, Law for Trade Companies

**JEL classification:** K22

## 1. Introduction

In economy or more precisely in business activities, the complexity of social relations especially the circumstances wherein such business activities are taking part, and of course considering the scope and way of performing such activities, it's necessary several persons mutually to act and in such cases we are talking about meeting the individual interests of each. Such mutual business activities beside the purpose to meet individual interests of each person, contributes for fulfillment of mutual interest of individuals who joined. Thereby the association is realized as different types of companies as legal form for mutual associated activities. Therefore the nature of relations in the companies, especially the need to protect persons acting within as well as all third individuals contacted by, impose inquiry for legal regulation of many questions considering the scope of regulation and special characteristics of each of those associations.

On the level of the modern stadium of existence of free competition regarding realization of trade activities, the selection of the type of company through which the associates would accomplish their mutual interests, is free and unlimited by regulations, although the legal form of the company wherein such association could be realized is normatively regulated. While the classification of the companies according to special characteristics of each, facilitates associates decision which legal form to be chosen. In legal system exist regulations by which the types of companies wherein the association can be realized are strictly determined, therefore this is no left to will of associates, to establish a company for which no provisions in existing legislation exist i.e. exist *numerus clausus* of companies. Regulations determine characteristics of certain companies, but still having certain dimension for autonomic regulation of its relations. Such legal intervention is required in order to protect the creditors' interests, associates' interests as well as public interests.

Dispositive regulations, anyhow enable private autonomy of associates concerning regulation of relations in company, but as such, they also fill the legal gap in contracts for establishing companies, if associates left any items unregulated.

The associates as most interested subjects in regard with the characteristics and the legal regime of the company established by them, in the process of selecting the type of the concrete company, start from the position if such company will satisfy their business interests. After deciding for using certain type of company, they autonomously regulate internal structure and mutual relations as those most appropriate for them, while have to obey the provisions of compulsory nature. So, in the process of association it's essentially the associates to decide, in such case, within which type of company they will associate because the provisions application depends on that, as well as the way of fulfilling the legal gap not regulated thereby.

In selecting the type of company by associates, main stream is the target that should be achieved by such association. In all that not less significant is the status the associates have at that company, considering the expectations of any of them would like to accomplish by such association especially if in such company the associates should invest any capital, or if they should have any material liability toward third parties in relation with external business relations of the company etc.

Special importance also has the wish of certain associate if wants to be engaged within the business activities of the company in any of its forms, i.e. if will take part only in making decisions or will also take part in managing the company's activities.

All those above mentioned targets and wishes of the associates, as well as many others which can not be mentioned herein due to limited space we have, enable the interested subjects to select type of company wherein will be associated and which is the most appropriate for their wishes and interests.

Herein, as well, due to limited available space we have, will be briefly elaborated the legal characteristics of the associations as partnership, cooperative, public trade company and company with limited liability considering their mutual characteristics especially those approaching to personal types of companies i.e. companies of persons wherein the personal characteristics of the associates play a crucial role in determining the type of company wherein they will associate. So,

**THE PARTNERSHIP** which according to Article 667 of the Law on Obligations (hereinafter referred as LOO)<sup>1</sup> is characterized by the fact that by the Contract for partnership of two<sup>2</sup> or more persons partners, they are mutually obligated to associate their property and labor or part of their property and labor, for the purpose of joint realization proceeds and profit allocation, is a typical personal association wherein the personal characteristics of each associate play crucial role for others to associate with ;

**THE COOPERATIVE**, on other side is characterized by association of physical or legal entities for the purpose of promotion or protection of certain number strictly defined economical interests, within all main operating activities except in banking and insurance as well as activities being prohibited by the Law to establish cooperative – Article 2 of the Law for cooperatives<sup>3</sup> (hereinafter referred as LC) ;

**PUBLIC TRADE COMPANY** which is typically personal company, according to Article 110 of the Law for trade companies (hereinafter referred as LTC )<sup>4</sup> is a trade company wherein, according to the Contract, are associated two or more physical and legal entities<sup>5</sup> who are liable in front of the creditors for Company's obligations without any limitations and jointly with their entire property ;

**THE COMPANY WITH LIMITED LIABILITY(Ltd.)** as Company of capital, which in some significant characteristics is quite different from above mentioned, also is very closed to personal companies, if the main orientation for the associates is to perform the association by taking into consideration their personal characteristics. Namely, according to Article 166 of the LTC, Company with limited liability is company wherein, according to Company's Contract, one or more physical and legal entities participate with up to one investment within the agreed in advance main capital of the company while the Shareholders are not liable for the Company's obligations.

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<sup>1</sup> Služben vesnik na RM (Official Gazette of RM) No. 18/01, 4/02 , 5/03, 84/08 161/09 .

<sup>2</sup> Example exception is English law - Companies Act of 1985 sets up partnerships lower limit of 20 partners - Barbi J. (2002): page 6-7

<sup>3</sup> Služben vesnik na RM (Official Gazette of RM) No. 54/02, 84/05

<sup>4</sup> Služben vesnik na RM (Official Gazette of RM) No. 28/2004, 84/2005, 25/2007, 87/2008, 42/2010, 48/2010

<sup>5</sup> In Switzerland, membership is limited only to physical entites - Guhl,T. (1994): p.691

## **2. Characteristics related to way of establishing and entities who are establishing the Company**

The establishment of all those companies except for the cooperative is made by Contract. Namely,

- **The Contract for the partnership** is made in written form and any amendments of the same requires consent given by all partners. That means that any verification of signatures at Notary Public is not required. Since the partnership is not a legal entity and should not be registered in any public registers, minimal mandatory content of the Contract is not instructed, so the partners are free for any content implemented within. The main characteristic of partnership as form of association is relations between the partners themselves and their mutual trust, as well as the impossibility the partner to assign the partnership investment to third entity in case such third entity has became partner instead of him/her. Undoubtedly the partnership is personal company established considering the partners personality<sup>6</sup>.

- **The Cooperative**, as opposed to partnership, to Public Trade Company and the Company with limited liability is established on the founding assembly which enacts the Statute and cooperative members acquire right to sign that Statute. The founding assembly approves all written reports prepared and delivered by the shareholders and appoints the cooperative's bodies.<sup>7</sup> Since the cooperative is founded for the purpose to promote or to protect certain number of strictly defined economical interests and since it's concerning membership in the cooperative, when the receipt of every member should be approved by its assembly or any other body determined by the Statute of the cooperative, and since it's not possible to make transfer of the membership to third entity without having decision for the receipt of the new member in the cooperative, it can be argued that the cooperative is also close to personal companies i.e. same is founded on the basis of certain characteristics of each it's member.

- **The Contract for the public trade company and for the company with limited liability** have strictly instructed minimal content, by denoting names of shareholders, name of company and its registered office, scope of operation, its management and representation, as well as

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<sup>6</sup> avdar K. (2011): p.877-879

<sup>7</sup> Nedkov, M. Beli anec, (2008):p.637-639

other items arising out from the character of the Public Trade Company i.e. the Company with limited liability. Here the possibility to transfer the capital investment of the Public Trade Company to third entity only by having consent of all shareholders undoubtedly leads to conclusion that the Public Trade Company is established on basis of the character of each shareholder, therefore it's personal company par excellence. Also, possibility at the Company with limited liability, by its Contract, to limit or to be conditioned by certain assumptions concerning the capital investment transfer to third entity even if it is by way of inheritance, indicates the familiarity of Ltd. with personal companies.

So common feature of the Public Trade Company, the Company with limited liability and the Cooperative, is that, by their registration into the trade register, they acquire status of legal entity. As previously noted, partnership can not acquire status of legal entity neither can be registered in any public register.

### **3. Characteristics related to the property of companies**

Since the fact that property means collection of subjective property rights and obligations to one certain legal entity, for those companies wherein partnership is also included, even though it's not legal entity, it should be determined who is holder of such rights and obligations, while it's previously necessary to elaborate how the property of those companies is created. Namely,

- the property of the **partnership** is constituted by partners' capital investments ( main capital ) as well as the property acquired during the partnership activity and the partners are owners of the partnership property. One of main obligations of each partners is to invest in partnership which investment can be money, goods, rights and labor. If not otherwise agreed in partnership agreement, it is assumed that the partner's investments are equal. Investments determined by the partnership agreement can be additionally increased only by having consent by all partners while as investment increasing can be considered the profit realized during such partnership. The partner can not possess part of property under ownership<sup>8</sup> of other partners neither can possess certain investments being parts of that property;

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<sup>8</sup> Gorenc, V.(1998): p.834

- the property of the **Cooperative** is created by investing capital investments by cooperate society members who are creating the main capital of the cooperative, which investments can be monetary and non-monetary while in the Cooperative's Statute are included provisions concerning its property, way of investing, legal regime for the acquired real estate property or movable property, as well as all data regarding people that invested any goods or rights. Holder of the property of the cooperative is the cooperative itself that acquires legal entity status by its registration into Trade Register<sup>9</sup> ;

- the property of the **Public Trade Company** is consist of capital investments of shareholders while the Company's Agreement includes provisions regarding the type and the amount of the investments of each shareholder, which investment can be money, goods, rights, labor and services. The type and the amount of the investment of each shareholder are registered in Trade Register. The shareholder of the public company is not obligated to increase its investment above the amount determined by the Company's Agreement, neither in case of loss to compensate the same if it's decreased not by his fault. Withdrawal of capital investment may be required by the shareholder only in case of termination of the shareholder's relation in that public company. Holder of the property of the Public Trade Company is the Company itself which the legal entity status acquires at the moment of its registration into the Trade Register;

- the property of the **Company with limited liability** is consist of capital investment of the shareholders which can be with different amounts and can be monetary and non-monetary and registered completely. Capital investments in form of labor and services including labor or services that are already preformed, are not allowed. Holder of the property of the Company which represents the overall of rights, property and other proprietary rights acquired by the Company over goods, money and rights invested by the shareholders or acquired by the Company during its functioning, is the Company with limited liability that acquires its legal entity status by its registration into the Trade Registry. Each shareholder of the Company with limited liability is holder of one capital investment determined by the size of the same taken over by that shareholder, if not otherwise determined by the Company's Agreement ;

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<sup>9</sup> Barbi J. (2002): p.657

#### **4. Characteristics related to bodies who are making decisions in the Company**

Making decisions in all those associations is made by body where participate all associates. So:

- At **partnership**, the right to manage the partnership activities belongs to all partners, while if not otherwise agreed within the Partnership Agreement, it is assumed that the partners' capital investment are equal. Since the partners are co-owners of the partnership property, in management of the partnership are applied, as logical, provisions as per Articles from 35 to 49 of the Law for property and other proprietary rights related to co-owner management with goods = analogue to partnership property<sup>10</sup>. In taking activities for regular management, consent given by the co-owners whose investments are more than a half of the goods value, is required. If it's not agreed, and the activities for the regular management of the work are necessities, competent will be the court. For taking over activities that exceed the framework of regular management, consent given by all co-owners is required, while if agreement will not be reached, the co-owners can ask for competence by the court ;

- At **Cooperative**, the highest authority i.e. body is the general assembly of cooperative society members. In this general assembly each cooperative member has one vote, if not otherwise determined by the Statute. Except when by law or by cooperative's statute is not assumed something else, decisions of the assembly are made by majority of votes of cooperative's members. This majority is valid as well for cases of voting by cooperative's members writing;

- At **Public Trade Company** each shareholder is authorized to manage the Company, while the Company's Agreement can specify that decisions which will be made by all shareholders should be made by decision making in written form, if shareholders didn't required to convene a meeting of founders i.e. meeting of shareholders. Decisions that exceed the authorizations related to regular activities of the Company, are made by the founders i.e. the shareholders unanimously if not otherwise determined by the Company's Agreement<sup>11</sup>. If by the Company's Agreement is determined decisions to be made by majority

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<sup>10</sup> avdar K. (2012): p.109-114

<sup>11</sup> Barbi J. (2002): p.312-313

of votes, then each founder i.e. shareholder has only one vote, if not otherwise determined within the Company's Agreement ;

- At **Company with limited liability** founders i.e. shareholders are making decisions for the Company at shareholders' meeting or in written form, while the shareholders meeting is consist of all founders i.e. shareholders. Each amount of the of share of each shareholder corresponding to amount of 100 EUR, gives one vote, while the parts under 100 EUR are not considered in voting right. In Company's Agreement can be determined the shareholders to have other right to vote than the one determined by the share amount while each shareholder has to have right to at least one vote. Quorum for the meeting is presence of shareholders that have majority of votes according to shares, if by the Company's Agreement is not determined higher majority.

## **5. Characteristics related to management and representation of the Company**

Management of each of those companies is regulated on different way where it's mostly determined by the liability of the Company for its obligations toward third entities elaborated below. So,-

- At **partnership** each partner can, without previous consent of other partners, perform all activities that do not exceed the framework of regular management of the partnership, but if any of partners will oppose it, decision made by all partners is required. When any of partners would violate the limits of regular management or limits of authorizations entrusted by other partners, then would be valid rules of management without a warrant. Each partner can perform the work immediately without previous consent given by other partners, otherwise the partnership threatens harm that otherwise could not be removed<sup>12</sup>. In case when the partners didn't achieve agreement, each partner is authorized to represent the partnership within the scope is authorized for its activities.

By the partnership agreement its management<sup>13</sup> can be entrusted to be realized by one or several partners (representatives) or by persons not being partnership members. If the manager is person who is not partner, relations between this person and the partnership is regulated by

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<sup>12</sup> avdar K. (2011): p.880-882

<sup>13</sup> Management of business partnership is any action that is being taken to achieve the common goal of partnership except that delves into the foundation of partnership - Ditfurth, H.(1995): p.121

special agreement. When there are several managers, they decide by majority of votes. When as manager is assigned one of partners, same can not resign without having justified reasons, otherwise would be liable for the damage.

- At **the Cooperative** management body is the Board of Managers elected by the Cooperative Assembly. The Board of Managers of the Cooperative must have at least three members while the majority of the members of that Board should be Cooperative members i.e. citizens of Republic of Macedonia with permanent residence on territory of RM. At least one member of the Managing Board should have authorization to represent the Cooperative which authorization is registered into the Court Register. The members of the Board of Managers are elected for the time period not less than four years and are eligible for re-election except if not otherwise regulated by the Cooperative's Statute<sup>14</sup>.

The General Assembly or the Managing Board, if so regulated by the Statute, can entrust the management of the Cooperative to one or several persons, managers not being members of the Cooperative. Persons entitled i.e. authorized to represent the Cooperative take over all legal activities and acts within the regular business of the Cooperative. Among other things, the Managing Board of the Cooperative performs control of persons authorized for managing the daily works of the Cooperative as well as of persons authorized to represent the Cooperative.

- At **Public Trade Company** each shareholder is authorized to manage the public company, while if the shareholders have agreed the management of the public company to entrust to one or several shareholders then other shareholders are excluded from its management. Management authorizations are related to activities that belong to regular Company's operating activities. Its managers are authorized to act independently in managing the Company. If according to the Company's Agreement, the managers act mutually then decisions are made by consent given by all managers. Each manager can fulfill all urgent actions independently if it prevents the occurrence of damage for the Company<sup>15</sup>. For all taken over activities the manager should without any delay to notify all other managers of the public company;

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<sup>14</sup> Nedkov, M. Beli anec, (2008): p.640-642

<sup>15</sup> Barbi J. (2002) p.316

- **Company with limited liability** is managed by its manager i.e. managers while the composition, the organization, the activities and the competencies of the management body are determined by the Company's Agreement. As a manager it can be elected any physical person who is being business capable. The manager can take over all legal activities and acts related to and usual for the business of the Company and in its interests. In relations with third entities the manager is authorized to act in all circumstances on behalf of the Company except for the authorizations which according to Law for trade companies and Company's Agreement, assigned to the shareholders.

The manager is obligated to obey the limitations of authorization for representation determined within the Company's Agreement, within the Decision made by the Shareholders' Assembly, but those limitations do not have any legal effect toward third entities even if the limitations were published. Manager who knew that has taken over activities on behalf of the Company without having authorizations for that will be personally liable in front of the Company for all caused damage.

#### **6. Characteristics related to liabilities of associates concerning obligations of the Company for third entities**

All those above mentioned four associations: the Partnership, the Public Trade Company, the Company with limited liability and the Cooperative differ among themselves in regard with the fact how the liability concerning obligations that each of those companies in their daily works takes over toward third entities is regulated by the Law. So,

- At **Partnership**, regarding its obligations, the partners are jointly liable, while for partnership debts and receivables, if not otherwise agreed, are applicable the provisions of the Law on Obligations for obligations with several debtors and trustees. The partner, can not, by right to work, to oblige the partnership without having consent given by other partners. Such consent can be given prior to Contract conclusion as license or after signing the Agreement as approval if not otherwise regulated by Law. Provisions of the Partnership Agreement by which the partners' liability is limited to the amount of their capital investments or on any other way, has legal effect for its trustees, only if they were notified for such limitations before signing the Agreement. Personal trustees of the partners can not ask to settle i.e. to cover their debts from

the partnership property, but the trustees of each partner can put veto on part of the profit that belongs to their debtor and to ask abstraction of the investment of their debtor from the partnership property. The partnership debtor can not compensate its receivables from any of partners neither the partnership can not compensate its receivables from its debtor with debt having to any of partners<sup>16</sup>.

- At **Cooperative** concerning the liability for Cooperative's obligations toward third entities, the Cooperative can be established:

- a) as Cooperative with unlimited liability of its members, or
- b) as Cooperative with limited liability of its members ;<sup>17</sup>

At Cooperative with unlimited liability, the Cooperative is liable for its obligations with all its property and at Cooperative with limited liability the Cooperative is liable for its obligations with all its property. By the Statute of the Cooperative with limited liability can be regulated that in case of liquidation or bankruptcy of the Cooperative the members will be subsidiary and jointly liable to pay certain additional amount which usually will be expressed as multiple amount of value of their capital investments at the Cooperative.

- At **Public Trade Company**, each shareholder is directly liable toward the trustees for Company's obligations, with all its property and jointly with all other shareholders. Trustee of Public Company can ask from the shareholders fulfillment of obligation of the Public Company only if the Public Company would not fulfill the obligation within the time period determined in the written call by the Trustee. Any new shareholder of Company which already exists, for obligations created before its acceding as shareholder at such Public Company, will be liable as all other shareholders.

- At **Company with limited liability** shareholders are not liable for Company's obligations. For its obligations toward third entities the Company with limited liability is liable with all its property.

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<sup>16</sup> avdar K. (2011): p.886-887

<sup>17</sup> Barbi J. (2002): p.698-702

Liability of shareholders of the Company with limited liability for the Company's obligations can appear only if presumptions as per **Article 28 of the Law for Trade Companies**<sup>18</sup>

### **Conclusion**

From global observations of this study above mentioned as well as according to many others characteristics of those associations which because of lack of space can not be elaborated here, can be concluded that at those associations we are talking about legal community of persons and property created with legal act and for the purpose of accomplishing certain aim wherein the associates are mutually related with proprietary rights and obligations determined by Law as well as by the Act by which the association is made. Therefore, characteristics of those associations thereby creating company for trade activities, would be the followings:

- a) it's about association of persons and properties;
- b) The Agreement is the fundament of association, except for the Cooperative where the Statute, signed by the cooperative members, is the fundament for association;
- c) The association is made for the purpose to achieve certain common target in trade activities;
- d) There is certain obligation for the shareholders, partners or cooperative members to contribute for achieving the target;
- e) That by the association is created legal entity at the Public Trade Company, Company with limited liability and at the Cooperative, while the Partnership is not created as legal entity;

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<sup>18</sup> By Article 28 of the Law for Trade Companies is regulated the following :

“ (1) Founder i.e. shareholders of the trade company have unlimited and joint liability for Company's obligations in cases if :

- 1) have abused the Company as legal entity in order to achieve targets which are forbidden for them as single persons ;
- 2) have abused the Company as legal entity in order to cause damage for their trustees;
- 3) against the Law, possessed the Company's property as own property , or
- 4) in own behalf or in any others behalf reduced the Company's property, and knew or had to know that the Company is not capable to perform its obligations toward third entities ;

- f) That the internal organization for making decisions and representation at Partnership and at the Public Trade Company is not regulated by law but is regulated by Association Agreement, while at the Company with limited liability and at the Cooperative its internal constitution and representation way of the Company i.e. of the Cooperative is regulated by Law.

In deciding which type of association to apply in order certain legal subject to be associated starting base is also the situation if the associates should be liable for the Company's obligations toward third entities directly and with all its property or only with investments paid for such association. Of course, third entities would have greater confidence in certain association if the liability for association obligations reaches the associates property. In that direction the Partnership and the Public Trade Company are characterized with same characteristics, with the difference that at Partnership the partners are liable directly and jointly for the partnership obligations, while at the Public Trade Company the shareholders are liable subsidiary i.e. when the receivables can not be settled by the Public Trade Company, but anyhow jointly and unlimited. Very similar is the liability at Cooperative which is established as Cooperative with unlimited liability. At the Company with limited liability the shareholders are liable toward the trustees only with their registered capital investments, if presumptions as per Article 28 of the Law for trade companies are not fulfilled. Similar is the liability of cooperative members established as Cooperative with limited liability.

According to exposure in this study, so it's surely that law regulations enable, in everyday life to have many associations in form being legally regulated by certain provisions, but the election of association form depends on concrete requirements of the associates and targets they would like to achieve by such association. The complexity of relations appearing in relation with and because of each association inquires from associates thoroughly to study all implications that may cause the association form they will decide for, while especially helpful will be the scientific and the professional analysis of each form of those associations, but also the placement of such associations in real practical life considering the certain circumstances and the surrounding wherein such business activities are taking part.

Certainly, this study is modest contribution in that direction.

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**Professional paper**

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## **CORPORATE TAXES AND THEIR POTENTIAL EFFECTS ON INVESTMENT**

### **Abstract**

The following article is aimed to explore the potential (theoretical) effects from corporate taxes on investment according to the source of finance. The purpose is to analyze the investment decision in the case of isolated implementation of corporate taxes through the methodological frame of the effective marginal tax rates. It explains that these conditions generate “uneven” distribution of the burden across the projects covered with different sources of finance. Also, some corporate tax systems with abilities to alleviate the burden are additionally presented and adequately analyzed. For example, a special attention is given to the following corporate tax systems, frequently met in the practice: the comprehensive business income tax system (CBIT), the imputation corporate tax system (ICT), the full imputation corporate tax system (FICT) and the split rate corporate tax system (SRCT). Hopefully, this analysis will prove that some corporate tax systems do have theoretical abilities to produce higher degree of neutrality and are effective for elimination of the distortion between the alternative sources of finance.

**Keywords:** corporate income tax, source of finance, imputation tax system, full imputation tax system, split rate system.

**JEL Classification Numbers:** H25, H32, D92

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## **Introduction**

Corporate taxation is very complicated matter if we consider the single fact that the corporate tax base (i.e. the corporate income) cannot be limited only at the corporation observed as a form of a legal entity. Usually, after the initial taxation at corporate level, corporate profits are distributed to the shareholders in a form of dividends, capital gains or interest payments, and are subject to additional taxation at personal level. Consequently, the effects from corporate taxation, very often depend on the cross-effects from the personal taxation. But, regardless the interaction with the personal income tax, the process of corporate taxation on itself, might result with some interesting effects emerging from its nature.

One of them is the privileged treatment of debt as a source of finance, as a result of the usual and widely excepted treatment of the interest expenses. Normally, since interest payments are tax deductible from the corporate tax base, the system subsidizes the debt source investment by reducing the discount rate. So, debt is considered as tax preferred as compared to equity. The last triggers unfavourable behaviour of the corporation, to use more borrowed capital, thus increasing the risk of bankruptcy and insolvency of the firm. Similarly, retained earnings are more preferred to new equity issues since capital gains are usually taxed upon realization or eventually exempted from taxation when reinvested. This commonly creates better position for the old mature companies as they possess more abundant accumulated reserves, as compared to their young inferior competitors.

In the following article, I explore the potential effects from the corporate taxes through the methodological frame of the effective marginal tax rates. The general intention is to analyze the investment decision in the case of isolated implementation of the corporate taxes, which implies a condition of total abstraction of the personal taxes<sup>1</sup>. I hope to prove that these conditions generate “uneven” distribution of the burden across the projects covered with different sources of finance. Also, the intention is to analyze the effects from the implementation of the corporate tax systems which have abilities to alleviate the burden, as

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<sup>1</sup> This condition ignores the effect from the “integrated - double” taxation. As a result, measurements of the effective corporate tax burden are expressed usually, at corporate level.

well as, to produce higher degree of neutrality in the process of taxation. They are: the comprehensive business income tax system (CBIT), the imputation corporate tax system (ICT), the full imputation corporate tax system (FICT) and the split rate corporate tax system (SRCT). Hopefully, this will contribute to the full picture of the effects from the process of taxation on investment at corporate level.

### **1. The proposed methodology**

Most of the authors agree that the best way to evaluate the effects from taxation on investment is through the measurement of the effective marginal tax rate (EMTR). According to Mervyn A. King & Don Fullerton<sup>2</sup> (1984), the measurement of effective tax rates may not be straightforward, but since the incentive for additional investment is function of the marginal tax rate, this requires a precise definition of the margin involved. They established the marginal investment as: “a small increase in the level of real investment in the domestic nonfinancial corporate sector, financed by an increase in the savings of domestic households” (King & Fullerton, 1984: 8). The authors propose the effective marginal tax rate as a ratio between the tax wedge and the pre-tax rate of return:

$$[1] \quad EMTR = \frac{\tilde{p} - s}{\tilde{p}}$$

Constructed as it's shown, the EMTR determines the share of return on a marginal unit of investment which is cut by taxation. Actually, EMTR represents a relevant indicator of the system's efficiency properties as it determines the extent of the available incentives built in the system. The most important component of the EMTR is term  $(\tilde{p} - s)$  which is also called “tax wedge” and it is an expression of the difference between the preference to invest and the preference to save. This term (the total tax wedge) can be divided into 2 parts: a) the investment tax wedge and b) the savings tax wedge.

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<sup>2</sup> The basic study on marginal effective tax rates was performed by King & Fullerton (1984). Because of its explicit theoretical foundations it's considered as a pioneer methodology in this field.

(Leibfritz, Thornton, Bibbie, 1997). The second term is measured as  $(r - s)$  and it represents the effective tax burden on the saver's income. The first term which is crucial for our analysis is measured as a difference between the investor's rate of return before taxes (the cost of capital) and the real interest rate  $(\tilde{p} - r)$  and it's an expression for the effective tax burden on the investor's (or company's) capital income.

Depending on the relation between  $\tilde{p}$  and  $r$ , we can distinct 3 (three) different conditions. The first condition is when the effective tax burden is positive ( $\tilde{p} > r$ ) and as a result of that, the tax system depresses the investment activities. The second one is when the effective tax burden is equal to 0 ( $\tilde{p} = r$ ), when the tax system is neutral to the investment decision. The third and the most preferrable condition from the investor's point of view is when the effective tax burden is negative ( $\tilde{p} < r$ ), when the tax system supports the overall investments. In perfect economies without presence of taxes, the cost of capital is identical with the real interest rate ( $\tilde{p} = r$ ) and the economic agents are completely indifferent between the investment decision and the decision to save. The existence of the national tax system diverges the difference between the cost of the capital and the interest rate and therefore creates a positive tax wedge ( $\tilde{p} > r$ ).

Identical concept of the EMTR is also advocated by the authors Devereux & Griffith (1999, 2002, 2003). The methodology developed by Devereux & Griffith extended the already existing concept proposed by King & Fullerton, which resulted in standardized methodology accepted by most of the economic organizations and institutions. The effective marginal tax rate on corporate income is defined identically as previously mentioned, where  $\tilde{p}$  is the cost of capital (pre-tax rate of return on investment) defined as:

$$[2] \quad \tilde{p} = \frac{(1 - A)\{ \dots + u(1 + f) - f \}}{(1 + f)(1 - t)} - \frac{F(1 + \dots)}{\chi(1 + f)(1 - t)} - u$$

where:

- symbol  $t$  is the corporate income tax rate;
- symbol  $u$  is known as the shareholders discount rate, which in absence of personal taxes generates value equal to the nominal interest rate ( $u = i$ );
- symbol  $\chi$  is the tax discrimination variable developed to measure tax discrimination between new equity and distributions. Under the condition of absence of the personal taxes, this variable has value of 1 ( $\chi = 1$ );

- symbol  $\pi$  is the inflation rate in the current period;  
 - symbol  $A$  is the net present value of tax depreciation allowances;  
 - symbol  $\delta$  is the economic (true) depreciation rate; and  
 - symbol  $F$  from the expression above represents the financial constraints variable and its value depends from the source of finance. According to Devereux & Griffith (1999), if the project is financed by reinvestment of retained earnings, the financial constraints variable  $F^{RE}$  will always generate value of zero ( $F^{RE} = 0$ ). If the project is financed through new equity issues, than the financial constraints variable  $F^{NE}$  is measured as:

$$[3] \quad F^{NE} = -\frac{\dots(1-\chi)}{(1+\dots)}$$

but since the value of tax discrimination variable is 1, this implies also that  $F^{NE} = 0$  ( $F^{NE} = F^{RE} = 0$ ). If the firm borrows external debt (bonds or bank loans) to finance its project, in that case than the financial constraints variable  $F^{DE}$  is measured as:

$$[4] \quad F^{DE} = \frac{\chi(\dots - i(1-t))}{(1+\dots)} = \frac{\dots - i(1-t)}{(1+\dots)}$$

In order to simplify the calculation for the purpose of a better illustration of the effects, I propose some simple, but very useful assumptions. For example, if the net-present value of depreciation allowances is assumed 0 ( $A = 0$ ), there is no inflation in the economy ( $\pi = 0$ ,  $\delta = r$ ) and the rate of economic depreciation is also assumed to be 0 ( $\chi = 0$ ), than expression [2] for the cost of capital will automatically transform to:

$$[5] \quad \tilde{p} = \frac{r}{(1-t)} - \frac{F(1+r)}{(1-t)}$$

and expression [4] for the financial constraints variable  $F^{DE}$  will obtain value of:

$$[6] \quad F^{DE} = \frac{r - r(1-t)}{(1+r)} = \frac{r - r + rt}{(1+r)} = \frac{rt}{(1+r)}$$

## 2. The effects from corporate taxes on investment

In the following section I use these analytical components to calculate and investigate the effects from the implementation of corporate taxes on economic performance of the firm. It must be noticed once again, that the measurements of the effective tax burden on investment are expressed only at corporate level, under the assumption of ignorance of the personal taxes. First, the usual, normal treatment of investment will be presented, in order to determine the most common tax practices. Then, the effects from the implementation of the comprehensive business income tax system (CBIT), the imputation corporate tax system (ICT), the full imputation corporate tax system (FICT) and the split rate corporate tax system (SRCT) will be analyzed additionally.

### 2.1. The usual, normal treatment of investment

**Debt.** Lets analyze the case of debt finance investment. For example, if the project is financed with debt, than the most common practice allows the corporation to deduct the interest payments from its corporate tax base. This means that the value of financial constraints variable  $F^{DE}$  from expression [6] will occur in expression [5] for the cost of capital:

$$\begin{aligned}
 [7] \quad \tilde{p} &= \frac{r}{(1-t)} - \frac{F(1+r)}{(1-t)} = \frac{r}{(1-t)} - \frac{\frac{rt}{(1+r)}(1+r)}{(1-t)} = \frac{r}{(1-t)} - \frac{rt}{(1-t)} = \\
 &= \frac{r(1-t)}{(1-t)} = r
 \end{aligned}$$

From here, it is easy to determine the value of the investment tax wedge:

$$[8] \quad \tilde{p} - r = r - r = 0$$

This indicates on the fact, that when the investment project is financed with external debt, the corporate tax system is neutral to the investment decision.

**New equity issue and retained earnings.** Since the tax discrimination variable is equal to 1, this implicates identical values of the financial constraints variables in the cases when the project is covered with new equity issues and retained earnings ( $F^{NE} = F^{RE} = 0$ ). This will

result with elimination of the second term of expression [5], thus generating value for the cost of the capital of only:

$$[9] \quad \tilde{p} = \frac{r}{(1-t)}$$

If term [9] is integrated in term [8], than the investment tax wedge will generate value of:

$$[10] \quad \tilde{p} - r = \frac{r}{(1-t)} - r = \frac{r}{(1-t)} - r \frac{(1-t)}{(1-t)} = \frac{r - r(1-t)}{(1-t)} = \frac{r - r + rt}{(1-t)} = \frac{rt}{(1-t)}$$

The result implicates that there is a positive tax burden on corporate income in every case of equity financed investments. Actually, this is the exact reason why, it is thought for the corporate income tax to be a “tax on the return on equity”. Simply, since interest payments are in fact tax deductible from the corporate income tax base, debt source of finance is considered as tax preferred as compared to the equity source of finance. The key factor influencing this condition is called „tax shield“ effect seen in term  $r(1 - t)$  from expression [6]. Actually, the system subsidizes the debt source investment by reducing the discount rate (which in this case is identical with the real interest rate) in proportion of the corporate income tax rate. The value maximizing firm will always tend to use more frequently borrowed capital as a part of its strategy for optimization of the capital structure, but in terms of the economic efficiency, this is a classical distortion because it increases the risk of bankruptcy and insolvency of the firm.

## **2.2. Comprehensive business income tax system (CBIT)**

The question which is raised here is: “What might the authorities do, to eliminate this equity-debt related distortion and to equalize the treatment between debt and equity. One of the answers is to implement the so-called “Comprehensive business income tax system - CBIT”. This regime successfully eliminates the need for integration between the corporate and personal taxes on equity by creating a restriction on the possibility for deduction of the interest expenses. In fact, interest expenses are no longer deductible from the corporate income tax base. “The corporation is therefore indifferent between debt, newly issued equity and retained earnings as source of finance of its investment under the CBIT” (OECD, 2007: 89). In order to express the effect from the

implementation of the CBIT system, the possibilities for deduction of the interest payment must be eliminated in term [6]:  $r(1 - t) = r(1 - 0) = r$ . As a result, the value of  $F^{DE}$  will generate value of zero ( $F^{DE} = F^{RE} = F^{NE} = 0$ ), thus equalizing the tax treatment of debt, new equity issues and retained earnings.

### 2.3. Imputation corporate tax system (ICT)

Another great example for neutral corporate tax system is the so-called “Imputation corporate tax system - ICT”. Basically, “with an imputation system of corporation tax, part of the company's tax bill is imputed to the stockholders” (King & Fullerton, 1984: 22). If  $c$  is considered to be the tax credit rate (or the rate of imputation), than the tax discrimination variable in absence of the personal taxes will be rewritten as:

$$[11] \quad x = \frac{1}{(1 - c)}$$

This will have certain implications on the other relevant variables, such as the cost of capital, where in expression [5], the tax discrimination variable will reappear:

$$[12] \quad \tilde{p} = \frac{r}{(1 - t)} - \frac{F(1 + r)}{x(1 - t)}$$

Now, let's analyze the effects on the different alternative investments.

**Debt source of finance.** The financial constraints variable for the investments financed with external debt under the conditions of the imputation tax system is calculated as:

$$[13] \quad F^{DE} = \frac{x[r - r(1 - t)]}{(1 + r)} = \frac{x[r - r + rt]}{(1 + r)} = \frac{xrt}{(1 + r)}$$

If term [13] is imputed in expression [12], the result for the cost of capital will be:

$$[14] \quad \tilde{p} = \frac{r}{(1 - t)} - \frac{\frac{xrt}{(1 + r)}(1 + r)}{x(1 - t)} = \frac{r}{(1 - t)} - \frac{rt}{(1 - t)} = \frac{r(1 - t)}{(1 - t)} = r$$

From here, if the investment tax wedge is calculated, it is obvious that the ICT system does not generate any other significant effect for the investments covered with debt.

$$[15] \quad \tilde{p} - r = r - r = 0$$

**New equity issues:** Since has value different from 1, the financial constraints variable in case of investment supported with new equity issues is measured as:

$$[16] \quad F^{NE} = -\frac{r(1-x)}{(1+r)}$$

Inserting the term [16] in the expression [12], the cost of capital will generate value of:

$$[17] \quad \tilde{p} = \frac{r}{(1-t)} - \frac{-\frac{r(1-x)}{(1+r)}(1+r)}{x(1-t)} = \frac{r}{(1-t)} - \frac{-r(1-x)}{x(1-t)} = \\ = \frac{r x}{(1-t)x} - \frac{-r(1-x)}{(1-t)x} = \frac{r x + r - r x}{(1-t)x} = \frac{r}{(1-t)x}$$

For the value of the tax discrimination variable from expression [11], the cost of capital will transform to:

$$[18] \quad \tilde{p} = \frac{r}{(1-t)} \frac{1}{(1-c)} = \frac{r}{(1-t)} = \frac{r(1-c)}{(1-t)}$$

And the investment tax wedge to:

$$[19] \quad \tilde{p} - r = \frac{r(1-c)}{(1-t)} - r = \frac{r(1-c)}{(1-t)} - \frac{r(1-t)}{(1-t)} = \frac{r - rc - r + rt}{(1-t)} = \\ = \frac{rt - rc}{(1-t)} = \frac{r(t-c)}{(1-t)}$$

This means that the corporate tax burden on investments financed with new equity issues, under the conditions of this system depends from the interrelation of the corporate income tax rate  $t$  and the rate of imputation  $c$ . Also, it indicates on the negative correlation between the tax burden and the imputation rate. As a conclusion, corporate systems with higher degree of imputation will support investments covered with new equity issues.

**Retained earnings.** It is very interesting that in this particular case, the imputation tax system does not generate any additional effect. Because, the financial constraints variable for the alternative financed

with retentions is always zero ( $F^{RE} = 0$ ), the result for the investment tax wedge is identical as the one from expression [10]. If the last three 3 alternatives are compared, it can be noticed that the imputation system is effective only for the second one. So, it is especially designed for alleviation of the burden for the projects primarily financed with equity issues.

#### 2.4. Full imputation corporate tax system (FICT)

In theory, this system treats the corporation as a pass through entity and allocates all the corporate profits at the shareholder level, where it is subject to the personal income tax. “Under full integration (full imputation), all corporate earnings – distributed dividends, retained profits and interest payments – are allocated to shareholders and bondholders and are taxed at the personal level at the personal income tax rate” (OECD, 2007: 86). Actually this system represents another variant of the imputation corporate tax system, where the imputation rate  $c$  (or the available tax credit rate) is equal to the tax liabilities paid at corporate level  $t$  ( $c = t$ ):

$$[20] \quad x = \frac{1}{(1-c)} = \frac{1}{(1-t)}$$

It is already mentioned that these systems (the imputation systems) do not affect the investment financed with debt and retentions. Consequently, the results for these investment alternatives are the same as in the previous section. Yet in the following paragraph I present the analytical proof only for the alternative with new equity issues.

**New equity issues.** If the conditions for the FICT ( $c = t$ ) are implemented, the investment tax wedge from expression [19] will become:

$$[21] \quad \tilde{p} - r = \frac{r(t-c)}{(1-t)} = \frac{r(t-t)}{(1-t)} = 0$$

This implies on the conclusion that the FICT system effectively removes the tax differences between external equity (new equity issues) and debt and at the same time favours external equity instead of retentions.

## **2.5. Split rate corporate tax system (SRCT)**

Another option for alleviation of the corporate tax burden is the split rate corporate tax system – SRCT. “Under a split rate system there are 2 different statutory tax rates, one that applies to retained earnings, the other to distributed earnings” (Devereux & Griffith, 1999: 48). Tax authorities might choose between the 2 different strategies concerning the split rate system. First, is the strategy to apply a lower rate (alternatively zero rate) on distributed profits which will serve to compensate for the personal tax paid on dividend income. The other strategy is to levy a lower split rate (optionally zero rate) on retained accumulated earnings instead on distributed profits. In the following section, the effects from the alternative strategies described above are additionally analyzed.

### **2.5.1. Taxation of distributions, retained profits exempt from taxation ( $t_d, t = 0$ )**

The first option is the strategy of taxation of distributed profits with retained profits exempt from taxation, which implies the condition of ( $t_d, t = 0$ ). The implementation of the terms of this condition generates value for the tax discrimination variable of:

$$[22] \quad x = \frac{(1-t_d)}{(1-t)} = \frac{(1-t_d)}{(1-0)} = (1-t_d)$$

And adequately, different value for the cost of capital:

$$[23] \quad \tilde{p} = \frac{r}{(1-t)} - \frac{F(1+r)}{x(1-t)} = \frac{r}{(1-0)} - \frac{F(1+r)}{(1-t_d)(1-0)} = r - \frac{F(1+r)}{(1-t_d)}$$

In practice, Republic of Macedonia and Estonia already have an experience with this variant of split corporate tax system.<sup>3</sup> The aim of this strategy is to generate strong incentives for reinvestment of retained profits, and reduce the chances for their consumption in a form of dividend distributions. Now the effects on different investment alternatives are compared, to see if the previous thesis can be properly confirmed.

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<sup>3</sup> In Macedonia, corporate profits are only taxed, if they are distributed with a 10% tax rate. This measure is which is originally called “Tax exemption on undistributed earnings”, was implemented in 2009.

**Debt.** The financial constraints variable for investments financed with debt under the conditions of the split tax system ( $t_d, t = 0$ ) is calculated as:

$$[24] \quad F^{DE} = \frac{x[r - r(1-t)]}{(1+r)} = \frac{x[r - r(1-0)]}{(1+r)} = 0$$

For the cost of capital as:

$$[25] \quad \tilde{p} = r - \frac{F(1+r)}{(1-t_d)} = r - \frac{0(1+r)}{(1-t_d)} = r - 0 = r$$

And for the investment tax wedge:

$$[26] \quad \tilde{p} - r = r - r = 0$$

This is an obvious confirmation that even the split rate system that allows taxation of distributed profits and at the same time exempts the retained profits, will not affect the neutral position of the external debt as a source of finance.

**Retained earnings** ( $F^{NE} = F^{DE} = 0$ ). Since  $F^{NE} = 0$ , then the result for the investment alternative financed with retained earnings is identical with the case of debt finance investments.

**New equity issues.** Similarly, since  $\lambda$  has value different from 1, the financial constraints variable in case of investment financed with new equity issues is measured as:

$$[27] \quad F^{NE} = -\frac{r(1-\lambda)}{(1+r)}$$

If the value of tax discrimination variable from expression [22] is considered, than:

$$[28] \quad F^{NE} = -\frac{r(1-\lambda)}{(1+r)} = -\frac{r[1-(1-t_d)]}{(1+r)} = -\frac{r(1-1+t_d)}{(1+r)} = -\frac{rt_d}{(1+r)}$$

By inserting it in expression [23], the cost of capital will obtain value of:

$$[29] \quad \begin{aligned} \tilde{p} &= r - \frac{F(1+r)}{(1-t_d)} = r - \frac{\frac{-rt_d}{(1+r)}(1+r)}{(1-t_d)} = r - \frac{-rt_d}{(1-t_d)} = \\ &= r \frac{(1-t_d)}{(1-t_d)} - \frac{-rt_d}{(1-t_d)} = \frac{r - rt_d + rt_d}{(1-t_d)} = \frac{r}{(1-t_d)} \end{aligned}$$

And the investment tax wedge:

$$[30] \quad \tilde{p} - r = \frac{r}{(1-t_d)} - r = \frac{r}{(1-t_d)} - r \frac{(1-t_d)}{(1-t_d)} = \frac{r - r + rt_d}{(1-t_d)} = \frac{rt_d}{(1-t_d)}$$

An interpretation can be given to the previous that this variant of the split rate system ( $t_d, t = 0$ ), generates a positive tax burden on the investment financed with external equity which depends generally from the corporate tax rate applied on distributed profits  $t_d$ . With this approach in the tax policy, the authorities try to “convince” the investor not to distribute the profit, but to reinvest it, since the tax burden for the second alternative is significantly lower. Also, this approach in the policy restores the neutrality between debt and retained earnings.

### 2.5.2. Taxation of retained profits, distributions exempt from taxation ( $t_d = 0, t$ )

The second option is the strategy of taxation of retentions (retained profits) with profit distributions exempt from taxation, which in this case implies the condition of ( $t_d = 0, t$ ). The implementation of the terms above, generates value for the tax discrimination variable of:

$$[31] \quad x = \frac{(1-t_d)}{(1-t)} = \frac{(1-0)}{(1-t)} = \frac{1}{(1-t)}$$

And once again, adequately, different value for the cost of capital:

$$[32] \quad \tilde{p} = \frac{r}{(1-t)} - \frac{F(1+r)}{x(1-t)} = \frac{r}{(1-t)} - \frac{F(1+r)}{\frac{1}{(1-t)}(1-t)} = \frac{r}{(1-t)} - F(1+r)$$

Many of the developed countries, especially the ones with excessively high tax burden, such as Germany and Japan, very often used or use this variant of split rate taxation, as an appropriate method for compensation of the personal tax levied on dividend income. Additionally, the effects from its implementation are given for every investment alternative.

**Debt.** The financial constraints variable for investments financed with external debt under the conditions ( $t_d = 0, t$ ) is measured as:

$$\begin{aligned}
 [33] \quad F^{DE} &= \frac{\chi[r - r(1-t)]}{(1+r)} = \frac{\frac{1}{(1-t)}[r - r(1-t)]}{(1+r)} = \frac{\frac{[r - r(1-t)]}{(1-t)}}{(1+r)} = \\
 &= \frac{\frac{[r - r + rt]}{(1-t)}}{(1+r)} = \frac{rt}{(1-t)(1+r)}
 \end{aligned}$$

By integrating the value for  $F^{DE}$  in expression [32] for the cost of capital, the result will be:

$$\begin{aligned}
 [34] \quad \tilde{p} &= \frac{r}{(1-t)} - F(1+r) = \frac{r}{(1-t)} - \frac{rt}{(1-t)(1+r)}(1+r) = \frac{r - rt}{(1-t)} = \\
 &= \frac{r(1-t)}{(1-t)} = r
 \end{aligned}$$

And for the investment tax wedge:

$$[35] \quad \tilde{p} - r = r - r = 0$$

Once again, it has been proved that the neutral position of the external debt as a source of finance is unaffected by the process of corporate taxation in absence of personal taxes, regardless the implemented type of corporate tax system.

**New equity.** If the value of tax discrimination variable from expression [31] is considered for the purpose of calculation of the financial constraints variable  $F^{NE}$ , it will result in:

$$\begin{aligned}
 [36] \quad F^{NE} &= -\frac{r(1-\chi)}{(1+r)} = -\frac{r[1 - \frac{1}{(1-t)}]}{(1+r)} = -\frac{r[\frac{(1-t)}{(1-t)} - \frac{1}{(1-t)}]}{(1+r)} = \\
 &= -\frac{r\frac{(1-t-1)}{(1-t)}}{(1+r)} = -\frac{\frac{-rt}{(1-t)}}{(1+r)} = -\frac{-rt}{(1-t)(1+r)} = \frac{rt}{(1-t)(1+r)}
 \end{aligned}$$

This result from the calculation clearly indicates on the identical values between the financial constraints variable  $F^{DE}$  and  $F^{NE}$  ( $F^{DE} = F^{NE}$ ). As a consequence, a total identity will be established between the values of the investment tax wedge  $\tilde{p} - r$ , for the investment alternatives financed with debt and new equity issues.

**Retained earnings.** In this alternative, since  $F^{RE} = 0$ , then the value of cost of capital will become:

$$[37] \quad \tilde{p} = \frac{r}{(1-t)} - F(1+r) = \frac{r}{(1-t)} - 0(1+r) = \frac{r}{(1-t)}$$

And the one for investment tax wedge:

$$[38] \quad \tilde{p} - r = \frac{r}{(1-t)} - r = \frac{r}{(1-t)} - r \frac{(1-t)}{(1-t)} = \frac{r - r(1-t)}{(1-t)} = \frac{r - r + rt}{(1-t)} = \frac{rt}{(1-t)}$$

If a conclusion is made from the implementation of the split rate system with the terms of taxation of retained profits and exemption of distributed profits ( $t_d = 0, t$ ) it will indicate that this variant generates a positive tax burden on the investment financed with retentions. With this approach in the tax policy, the authorities actually equalize the treatment between debt and new equity with intention to deliver a certain compensation for the excessive tax burden levied on dividend distributions.

The following Table 1 presents the summary of all analyzed effects and conclusions.

**Table 1: The effects from taxation on investment performance (Only corporate taxes)**

<u>The usual, normal treatment</u>	<b>Investment tax wedge</b> $(\tilde{p} - r)$
<i>Debt</i>	0
<i>New equity issues</i>	$\frac{rt}{(1-t)}$
<i>Retained earnings</i>	$\frac{rt}{(1-t)}$
<u>Coprehensive business income tax system (CBIT)</u>	
<i>Debt</i>	$\frac{rt}{(1-t)}$
<i>New equity issues</i>	$\frac{rt}{(1-t)}$
<i>Retained earnings</i>	$\frac{rt}{(1-t)}$

<b><u>Imputation corporate tax system (ICT)</u></b>	
<i>Debt</i>	0
<i>New equity issues</i>	$\frac{r(t - c)}{(1 - t)}$
<i>Retained earnings</i>	$\frac{rt}{(1 - t)}$
<b><u>Full imputation corporate tax system (FICT)</u></b>	
<i>Debt</i>	0
<i>New equity issues</i>	0
<i>Retained earnings</i>	$\frac{rt}{(1 - t)}$
<b><u>Split rate corporate tax system (SRCT)</u></b>	
<b>Taxation of distributed profits, retained profits exempt from taxation (<math>t_d, t = 0</math>)</b>	
<i>Debt</i>	0
<i>New equity issues</i>	$\frac{rt_d}{(1 - t_d)}$
<i>Retained earnings</i>	0
<b>Taxation of retained profits, distributed profits exempt from taxation (<math>t_d = 0, t</math>)</b>	
<i>Debt</i>	0
<i>New equity issues</i>	0
<i>Retained earnings</i>	$\frac{rt}{(1 - t)}$

*Source: Summary and review of the author's calculations*

## Conclusions

This article explored the potential effects that arise from the isolated implementation of corporate taxes with the help of the marginal analysis. With an appropriate application of its analytical components, it managed to investigate the investment decision and the economic performance of the firm.

The first step was focused on the usual, normal treatment of investment. The result implicated that the implementation of the corporate taxes create “uneven” distribution of the burden across the projects covered with different sources of finance. Actually, in the case of equity financed investments there was a positive tax burden on corporate income, while the debt covered investments took neutral position.

In the second step, the effects from the alternative corporate tax systems were analyzed. For example, the comprehensive business income tax system (CBIT) successfully eliminates the tax differences between debt and equity by elimination of the possibility for deduction of the interest expenses. In the imputation corporate tax system (ICT), part of the company's tax bill is imputed to the stockholders, and the effect from the imputation depends from the interrelation of the corporate income tax rate and the rate of imputation. The full integration corporate tax system (FICT) system represents a variant of the imputation corporate tax system, where the imputation rate is equal to the tax liabilities paid at corporate level. Under a split rate corporate tax system (SRCT) there are two different statutory tax rates, one that applies to retained earnings, the other to distributed earnings. The first policy option is the strategy of taxation of distributed profits with retained profits exempt from taxation, which is aimed to generate strong incentives for reinvestment of retained profits. The second option is the strategy of taxation of retentions (retained profits) with profit distributions exempt from taxation, which is usually intended to deliver a certain compensation for the excessive tax burden levied on dividend distributions.

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**Professional paper**

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**UNCERTAINTY IN CREATING MACROECONOMIC POLICY:  
KNOWLEDGE, SKILLS AND (UN)PREDICTABILITY**

**Abstract**

“If economists could manage to get themselves thought of as humble and competent people on a level with dentists, that would be splendid.” (Keynes, 1931). If this were the case, macroeconomics would transform into a useful and routine type of engineering, which will prevent the emerging of recessions. However, the appearance of the financial crises started to change the economy postulates. The unpredictability of their conduct designates the dynamics of the science of macroeconomics and the need to adjust it to the contemporary economic status. The ongoing crisis undoubtedly proves that.

**Key words:** macroeconomics, science, economic entities, postulates, adjustment

**JEL Classification:** A11, B22, E00

**Introduction**

"Macroeconomists can be scholars (scientists) or problem solvers (engineers)" (9). Some of them are just predictors of economic performance. Few and a relatively small number of them are forecasting specialists. For the others, the forecasting is only a small part of what they do. One reason for this is that macroeconomists are not very good at

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predicting. It is difficult not just because of the imperfection of understanding the way the economy works, but much more because it is not possible to take into account all factors (economic and non-economic) that may affect future economic trends.

(Un)realized predictions about expected performance of the global economy and the individual national economies in the last 3-4 years (period of the world economic crisis) unambiguously confirmed the poor predictions of the economists. Macroeconomists' forecast for the performance in 2008 was not achieved because few of them foresaw the dramatic rise in oil prices and agricultural products in the first half, and the financial crisis in the second half of the year. The same results happened with the prediction of economic performance in 2012. In striving to project the economy in 2012, economists-predictors needed to answer some important questions, such as: "What will be the price of oil in 2012?"; "How will the crisis in the Euro zone influence the world and individual national economies?"; "Will there be war in Iran?"; "Will there be a big flood or drought in agricultural regions with opposite effects on quantities and prices of food?"; "What are the expectations of economic agents and how they relate to newly created economic conditions?".

Because the answers to these questions are quite uncertain, few macroeconomic predictors offer specific forecasts. Instead, they are usually combined with "optimistic" and "pessimistic" alternative scenarios. Evolution of such forecasts for the expected growth of the economy of the Republic of Macedonia in 2012 (from optimistic rate of 4.5 percent, to pessimistic negative growth rate), is another confirmation of the present uncertainty, and thus the inaccuracy of macroeconomic forecasts.

Thus, the uncertainties make forecasting of economic agents very difficult. Perhaps that is why instead of anticipating what will happen, "most macroeconomists are concerned with analyzing and interpreting events that occur (doing macroeconomic analysis) or seek to understand the structure of the economy (doing macroeconomic research)" ( Abel, Bernanke, Croushore, 2009). On the other hand, emerging problems require solutions from the macroeconomists-engineers.

Such problems emerging in front of the macroeconomic science are analyzed in this paper. Using descriptive, historical, statistical, deductive, inductive and experiential methods, the paper should answer the following questions: "Why are the results of macroeconomic analysis

an unreliable indicator of the achievements and developments in the economy?"; "What is the impact of uncertainties in predicting economic performance?"; "Should macroeconomics be a pure science that will only analyze the situation or should it be more than that - engineering that will address macroeconomic problems?". In preparation of this paper the analyses and proposals of several macroeconomic theorists and analysts are used, as well as subjective analysis and views of the authors of the text.

### **1. What is macroeconomics? Science or engineering?**

According to Mankiw (2006), "there are two types of macroeconomists: those who would like macroeconomics to be a science and those who understand macroeconomics as a kind of engineering. The goal of scientists is to understand how the world works. Engineers are always problem solvers."

Such division of macroeconomists is derived from the two dominant schools of economics: Classical and Keynesian. The first marked the development of macroeconomics during the middle Ages to the appearance of the grandiose work of John Maynard Keynes "General Theory of Employment, Interest and Money" in 1936. The second school has marked the development of macroeconomics from the appearance of Keynes to present day. Meanwhile, both schools were present in the economic science only with appropriate modifications (changes and adjustments) in their views, which were caused by significant changes in the world economy (Nenovski, 2010).

In XVIII and XIX century and early XX century the theory of English classical political economy dominated. Its founders were British economists Adam Smith and David Ricardo. Classical political economy strongly emphasized the role of the individual, his/her private property and initiative and the "invisible hand" of the market as the most effective regulator of economic life. In such conditions, there is no room for state intervention in the economy. Classical political economy accepts the teachings of the physiocrats of the "natural order", except that it considers that the "natural order" can be provided only by the capitalist system, and not by the feudalism in agriculture as dominant economic activity. The basic positions this economic school advocated were:

- The market has the power of self-regulation, leading to the rational use of available resources;
- There is no compulsory unemployment in capitalism;
- Supply automatically generates consumption (it is called Say's law). Therefore, there is no danger of significant difference between the aggregate supply and aggregate demand, and the emergence of economic crises. Obviously, classicists were more focused on economics as a science, i.e. analysis of how the system works.

The first weakness of the claims of the classical school of economics began to show in the late XIX and early XX century. It was the period of transformation of the liberal monopoly capitalism. On the market, large companies with monopolistic power (there was no competition) began to dominate and to direct economic policy according to their goals, needs and interests. Soon after World War I it was required that the economy switches from peacetime to wartime 'mode'. In such circumstances the state could not remain unattached as it happened until then. Private capitalist initiative and freedom were temporarily sacrificed to the interest of general security.

The Great recession occurred ten years after the war, from 1929 to 1933. It caused terrible decline in investment, output and employment, which further threatened the survival of the capitalist system. It dramatically denied the prevailing attitudes and assertions of the classical economic thought on how to run macroeconomic policy.

Indeed, their dominance in economic science ended with the appearance of the Keynes's grandiose book in 1936, in which, Keynes advocated contrary views and opinions from those of the classical school of economics. That book, like all Keynes's work, played a revolutionary role in guiding macroeconomics in solving economic problems worldwide.

Keynes was under strong impression of the consequences of the great global economic crisis, particularly the fall in investment, production and employment. That forced him to radically oppose the views and claims of classical economic thought, imposing a new world claim according to which:

- Unemployment is a regular occurrence;
- Supply cannot automatically create sufficient demand, but in case of discrepancy, the equilibrium can be established at a new, even lower level;

- Although theoretically their balance is desirable, investments and savings often diverge in practice, which leads to crises in the system and unemployment.

Such learning leads to the appearance of macroeconomics. First, macroeconomists (Mankiw, 2009) were engineers who were trying to solve practical problems, like the Great Recession. Most of them (Modigliani, Samuelson, Solow, Tobin and others) in their autobiographies confirm that the Great Recession was the main (key) motivator in their careers. Keynes and the creators of his model had the perspective of engineers. They were motivated by problems in the real world and after they developed their theories they waited to apply them in practice.

However, the problems that later emerged in the development of macroeconomics, especially the emergence of stagflation in the early 1970s, caused macroeconomists to be more interested in developing analytical tools and establishing theoretical principles. The Keynesian school was replaced by new ideas of classical economic thought. The monetarism first appeared with its most important representative Milton Friedman. His rule for stable growth of monetary aggregates has become legendary in determining the cause of the outbreak. He has also offered possibilities for the economy to get out of the recession which hit the world in 1929/1933 and the early 1970s. The next wave of new classical economics was the revolution of rational expectations. Lucas and others argued that Keynesian models are useless for the analysis of macroeconomic policy because they do not take the expectations of the economic subjects seriously.

The third wave of new classical economics introduced theories about the real business cycles (Kydland, Prescott, Ploseer and others). They were built on the assumption that prices adjust to clean up the market, which is quite different from Keynesian theory.

As a result of the three waves of new classical economics, the field of macroeconomics has become more rigorous and significantly associated with the instruments of macroeconomics. In other words, again macroeconomics turns to the analysis of how the system works (science).

Current world economic crisis has questioned the Keynesian economics again. Encouraged by the errors of the liberalism which dominated the last decade of the XX and much of the first decade in XXI century, Keynesians were back by offering their theories as a solution to

the crisis. Again, Keynesian theory dominated with its statements: unemployment increases because labor demand is too low to provide full employment at existing wages, labor demand is low because firms cannot sell everything at current prices; demand for manufacturing firms is inadequate because many consumers are unemployed, etc.

Recessions and depressions are the result of the magical circle of low demand, so the stimulation of demand can have multiple effects. Measures taken by the financial authorities in the U.S. and EU will undoubtedly confirm the Keynesian thesis. World output requires solutions for the crisis.

In this confrontation of the two schools of economics today, in a time of uncertainties and great challenges imposed by the global economic crisis, the question is: "What should we do?"; "To conclude or to solve problems (to act engineers)?". A more likely answer is that in times of crisis and after them we need solvers of problems! Basically, as Mankiw says, "God brought macroeconomists to the world not to propose and test elegant theories but to solve practical problems" (Mankiw, 2006)

However, can engineers find solutions without adequate scientific basis? And at the same time, how good can scientific tenets be in terms of uncertainties and unresolved major problems facing the world economy? "As the world generally needs scientists and engineers, it also needs the two types of macroeconomists. They simply have to play both roles. We believe that discipline would prosper more if macroeconomists always bear in mind that they have a dual role" (Mankiw, 2009). The main problem that both types will face is contained in the title of the next chapter.

## **2. How to act in conditions of uncertainty?**

The economists that offer forecasts are trying to present various scenarios that could occur at different choices of the basic elements of macroeconomic policy. Their prediction is usually comprised of three main parts that are used depending on the predictions from their sources. These parts are: available data, models for analysis and evaluation of results (Pianalto, 2010).

Data is a historical category. If the series are higher or longer, the value of the data and analyses are more reliable. Also, the permanency

(continuity) of data is very important. However, due to various reasons (statistical, methodological, political, economic and social events, etc.) the data presented in broken or incomplete series often set the dilemma of their accuracy and emphasize the uncertainty of their quality.

There are many uncertainties in the past data. Thus, a short series of data on economic conditions and development in the Republic of Macedonia (from 1992 onward), their non-compliance due to the frequent changes in their methodologies for determining and presenting, distortions due to various shock effects on the economy (disintegration of the Yugoslav market, the UN sanctions against Yugoslavia and the Greek embargo against the Republic of Macedonia, Kosovo refugees in the Republic of Macedonia in 1999, "war" on the territory of the Republic of Macedonia in 2001, etc.) confirm the uncertainty of the data on which macroeconomic analyses in the Republic of Macedonia are made. It is obvious that "uncertainty about the past is an important component of our uncertainty in the future" (Aikman et al., 2010).

Models for determination of the past and expected economic achievements are based on these data and the experiences in the past. However "despite the useful lessons that history gives us, it is arguable that none of the past experiences appears in exactly the same way. Simultaneously, the economy will inevitably change and evolve in ways that cannot be covered precisely by any mathematical model" (Pianalto, 2010).

For example, no econometric model could take into account the emergence of stagflation in the 1970s. The same happened in the last few years with the emergence of the global economic crisis, and deflation, which was much greater than inflation. These factors were not taken into account nor can be taken in the future by any econometric model before and after the crisis.

Because of these reasons, the available data and corresponding model should accommodate the third and perhaps most important economic part of economic forecasting - providing assessments of current and future economic conditions and trends. "The assessment (evaluation) of the balance between strength and power of history to current events is critical for the forecasting process, because ignoring any of them can easily lead to bad projections" (Pianalto, 2010).

Forecasting is a difficult job even under normal conditions. In times of great economic crisis like the current one, it becomes even more difficult and challenging work. Indeed, in times of uncertainty, the role of

assessment of the forecasters becomes very important. If the macroeconomists in the world had applied this unwritten rule and had seriously accepted the warnings from the Professor at Columbia University in the U.S. Nouriel Roubini in 2006/2007 for the upcoming threats to the global economy and the expected global economic crisis, maybe the crisis would not have happened or it would have happened to a lesser extent.

Let us recall the events of the development of the crisis. The initial phase of the recession in 2008 was modest. In the second quarter of the year the world economy began to recover and show signs of growth. According to economic models, it should be a sign that economic recovery begins. Indeed, the average recession in some countries took less than three months. However, during the summer of 2008 worrying information from the financial markets were presented.

It indicated unsustainable recovery of the economy. In September 2008 the financial crisis deepened with the bankruptcy of Lehman Brothers. Evaluations of forecasters for the upcoming performances of the economy began to dramatically change and had declining and even negative sizes.

Such developments indicated that economic models have become less useful, and that opinions of Roubini and few after him have become the most important. It has become increasingly clear that economic models cannot adequately address the financial intermediation that has got more complicated modern forms than before, nor how it affects the real economy. Economic models were not prepared to accept any response of the authorities of some countries in response to the crisis. Approving loans with interest rates near zero (as the FED did) and the implementation of the policy of quantitative monetary easing were totally unexpected and unsuited for economic models.

Accordingly, "because econometric models usually cannot (or insufficiently can) align and adjust the specific factors or structural changes (breaks), final analysis of results must rely on the assessment of experts. Their assessment of the current economic environment forms the basis for final evaluation of the results that are based on ongoing model projections" (ECB, 2011). For these reasons economists had to monitor current events closely and continuously perform assessment of the process of forecasting.

### **3. Practice changes the rules**

Such an approach is especially needed today. According to many indicators, analyses and assessments, the world is in the worst economic crisis since that of 1929/1933, and perhaps even bigger. According to the existing models, the larger the economic crisis is, the faster the recovery is. In the present case, it would mean that the economic cycle moves in the form of the Latin letter V – recession and fall to the bottom and then immediately to the expansive path of that cycle.

However, many analysts say that if we follow and analyze developments in the global economy over the past 2-3 years, we will find that the output from this crisis will be slow and that the global economic cycle moves in the form of a letter U or at worst, in the form of letter W, that would mean the emergence of double bottom in the economic cycle. There are at least two reasons (Pianalto, 2010) for slow growth and quick exit from the crisis. The first is the effect of prolonged unemployment and the second is the caution of consumers and businesses.

a) Millions of people lost their jobs due to recession. Their number was much higher compared to other recessions. Average unemployment rate of 5.5% in the U.S. rose to about 10% in late 2010, and in 2011 began to slowly decrease and reached about 8.2%. In EU countries, the average unemployment rate of around 7% increased to about 10%, with insignificant trends for its reduction (except for the Republic of Germany). In some EU countries (Spain, Greece) this rate was above 20 percent. The total number of unemployed in the European Union at the end of 2011 reached a record number of 24 million people.

"Usually, in times of recession, with GDP falling by 1 percentage point, the unemployment rate increases by seven tenths of 1 percentage points. In this recession, GDP fell by 4 percent, which would mean an increase in the unemployment rate for less than 3 percentage points. Unfortunately, it has more than 5 percentage points" (Pianalto, 2010).

This time the length of time when people are jobless is critical. As never before, almost half of those who lost their jobs could not find work again in the next 6 months. Practice confirms that, the longer someone is unemployed, the harder it is to find work. The analyses also confirmed that during the extended period of unemployment, workers lose their job skills; some jobs simply are not recoverable. Thus, workers who fail to find work may start to work at job positions that are unknown to them. That, of course, has a direct impact on the reduction of their productivity.

b) The crisis caused caution among economic agents as a result of the uncertainty about where a "new normal" or baseline could be. Many today seek "financial security". It forced them to delay significant purchases until conditions became clearer. Sales of real estate, cars and other goods significantly reduced. Businessmen are also careful. They usually make many decisions that are based on forecasts. However, they encounter numerous uncertainties in forecasts/projections for future economic conditions and trends. They do not consider new employments until it becomes clearer how the economic recovery and departure path along the prosperous economic cycle will be. Their caution stems from uncertainty regarding energy supply, the amount of taxes (in some EU countries they are raised) and environment (uncertainty about the future of the Euro and thus the Euro zone, political and possibly military resolution of the crisis in Iran, continuing crisis in some North African countries, the outcome of the presidential elections in the U.S., etc.). Such caution means restraint followed by modest employment, modest purchases of equipment, modest amounts of new buildings, etc.

Besides those two, there could be another important reason for the expected slow exit from the crisis. Among economists and governments of individual countries, there is no consensus on how the economy could easily get out of the crisis. Their views are diametrically opposite. In the U.S. the prevailing view is that increasing the money supply in the economy with very low interest rates (quantitative easing), despite the high budget deficit facing the U.S. economy, will stimulate growth and employment and return the U.S. economy on the prosperous path. On the other hand, the big debt crisis in the European Monetary Union has led many economists and politicians to propose and impose hard budget constraints and savings in the economy as an opportunity to painlessly recover debts and prevent the creation and accumulation of new debts. In such confrontation measures taken by the two most developed economic zones the danger of further stagnation of the economic crisis is hidden. Indeed, most forecasts indicate that the world economy, especially the EU economy, in 2012 will have stagnant or even negative rates of growth.

Thus, the standard rules of the science cannot find adequate equal application in the world economy attempts to resolve the crisis. On the other hand economists-engineers have equal access to solving this problem. Because of their opposing historical data, econometric models have poor value. More often in their exchange, estimates (forecasts) are

made about future economic performance, which, because of the array of uncertainties, is subject to dynamic changes in very short periods. History affirms that "projections were least reliable when times were uncertain" (Weale, 2011).

Indeed, "all forecasts are enveloped in an endless loop of uncertainty. Risks of forecasting are assessed by calculating scenarios for economic development in different external macroeconomic conditions in relation to the initial. A typical scenario involves alternative assumptions about future developments in oil prices, exchange rates or economic growth in important economic regions, such as in the U.S. and the EU. The scenario includes not only the calculation of direct effects, for example, the level of oil prices on national economy, but also the indirect effects that could occur through changes in demand and prices in other Member States in the Euro zone" (Austrian Central Bank, 2012). Such approach is applied by the National Bank of the Republic of Macedonia (NBRM). According to the statements by NBRM's governor, "NBRM also has alternative scenarios if negative forecasts about the future of the Euro are realized" (Bogov, 2011).

Thus, forecasts are needed for policy making. However, because today they are made in conditions of instability and uncertain predictability, another important factor should be taken into consideration: behavior and beliefs of the economic agents.

#### **4. Macroeconomic in condition of instability and the role of behavior and beliefs of economic agents**

Klain, one of the first who used the word "macroeconomics" (1946) claims (Mankiw, 2006): "More of the newly created mathematical models of the economic systems, especially theories of business cycles, are poorly linked to the behavior of the individual households or businesses, which must be the basis of all theories of economic behavior"!

A key difference economics and natural sciences is that in economics the key roles are played by the active decision-makers: households and businesses (economic entities). The economic results are determined by the way economic agents think and behave in conditions of uncertainty and their beliefs about the past, present and future. Their behavior is determined by the perception of uncertainty. If many people

are insecure about their future job prospects, they save more due caution. Because such behavior reduces consumption, it may force firms to reduce the number of jobs to compensate the lost profit.

Beliefs and expectations of the economic agents adjust over time in response to changes in the environment and, in turn, affect how the economic systems behave. Occasional sharp changes in expectations could result in adverse effects. Exactly what happened in autumn 2008 is firstly the financial crisis, and then the recession in the real sector. It drastically reduced the optimistic views of the economic subjects in the world. In economics, there are two approaches (Aikman et al, 2010) in the modeling of decision making under conditions of uncertainty: (a) standard, "rational" approach of "homo economicus", which assumes that beliefs are based on an efficient processing of available information, and (b) "behavioral" approach, which is derived from the literature on psychology which emphasizes the psychological lines that violate the assumptions emphasizing "rational" views.

There is strong experimental evidence that people are subject to bias when collecting and processing information in terms of uncertainty and that such processing appears only occasionally (with interruptions). For example, enhanced information on the growing debt crisis forces the economic entities to refrain from intensive and riskier investments in the anticipation of better future information.

However, the aspects of the behavioral approach are:

- The practice confirms that there is no rule according to which perceptions of risk are under the dominant influence on recent or personal experiences. Such an effect explains why the fear of financial crisis decreases over time as the memories of the last one fade away;

- People tend to follow the actions of others. This could be an effective strategy. This type of behavior reflects the fact that economic agents are willing to experiment with the possible risks using strategies that are different from normal (usual). The penalty for such an error can be smaller if others made the same mistake. Indeed, such was the case with several banks which originally almost went bankrupt and later with the help of financial interventions by the governments and central banks of individual countries got out of the crisis.

These observations for decision making under conditions of uncertainty in the economy have implications for macroeconomic policy in three dimensions (Aikman et al, 2010):

First, the decision which is made under conditions of uncertainty affects the dynamics of the economy. Ignoring how people react under conditions of uncertainty, together with the feedback between behavioral performance and expectations, we highlight some of the difficulties and disadvantages in making economic policy;

Second, recognizing that beliefs and attitudes play an important role in the dynamics of the system affects whether the actions of policy are considered acceptable. For example, in the midst of the greatest intensity of the global economic crisis (mid 2009), the Prime Minister of the Republic of Macedonia stayed calm and even eliminated the distrust of depositors in banks with a statement: if the collapse of the banks happens, the Government will reimburse all amounts to, eventually, lost assets;

Third, communication between economic agents is part of the response of macroeconomic policy for the uncertainty. Because people's beliefs about future policy actions affect their behavior today, the strategy to control the economic system should include not only a plan for establishing such instruments (e.g. increase in bank interest rates if inflation rise is expected), but also a plan to determine beliefs about how decision makers will act in the future.

So, predictability involves the communication of the economic policy makers with the public. Communication strategy involves deciding how much information should be communicated and in what form. Any information used costs. The optimal communication strategy makes balance between the advantages and costs.

Let us consider first the advantages. The available information can improve the quality of the decisions of economic agents. Many government agencies have valuable information that ordinary citizens cannot easily access. For example, the NBRM has information about the shocks that hit the economy and how the country's policy intends to respond to them. If people get information, they can reduce their errors in forecasting and making decision.

Communication could help in coordinating beliefs, so that would replace bad with good behavior. Suppose that private investors are starting to question the soundness of a bank for which the Central bank knows that it is solvent. A signal from the Central bank that this particular bank is solvent can change the beliefs of economic agents and thereby can ensure continued liquidity and solvency of the bank. For example, when in mid-autumn in 2011 the debt crisis culminated in the

EMU and threatened the Euro, through several releases and statements the Governor of NBRM presented satisfactory solvency of the Macedonian banks and said that there is no danger for the safety of citizens' saving deposits. He also presented the soundness of the Macedonian currency (MKD - Macedonian denar). In an eventual collapse of the Euro, any savings in Euros would convert into MKD without any loss. At that moment, it eliminated the concerns of citizens and they did not withdraw their savings from banks, and it also increased their volume, especially in domestic currency.

Despite the advantages, communication sometimes may contribute to worsening of the mistakes of the market. For example, if the Government had announced that because of the budget deficit tax rates on economic subjects will increase in near future that would have been a signal to the economic subjects to reduce activity or to find ways to avoid or reduce the additional tax burden. Lesser transparency could mitigate this problem.

### **Conclusion**

The basic dilemma that arises from this analysis is whether macroeconomics is a science or engineering, or whether the uncertainties of today have turned macroeconomics into a science of prediction.

If one treats it like a science, it should answer the question how the world economy works. However, although the basic elements of macroeconomics as a science are known, it gives a partial answer to the question why the world entered a new major economic crisis and how easily it could be solve. Conspirators of the classical political economy consider that the output of the current economic crisis should be sought in the growth of the national output, and most importantly, the budgetary savings and establishment of a financial discipline. This approach is already established within the EU, but without significant visible results. Estimates of the opposite side are that the austerity measures of the crisis will further deepen.

On the other hand there are the Keynesians, the ones who propose macroeconomics to be a problem solver. They offer enhanced fiscal spending in order to stimulate growth and to pull the economy out of recession. However, their approach, which in the past 2-3 years was applied in the U.S., does not give the expected positive results.

In both cases experience and data are used, as well as known econometric models that should determine the direction of the economy in the future. However, incompleteness and uncertainty of the data and a range of uncertainties hanging over the global economy devalue the results of econometric models. Of course, this does not mean that standard macroeconomic models have no impact on the conduct of macroeconomic policy. The economic crisis that began in 2008 did not annul the economic analyses made before the crisis, although they have proved irrelevant in trying to discover the causes and find appropriate solutions for the financial crisis. These models showed significant deficiencies because the behavior of consumers and economic operators, who are leading drivers of the economy, were largely unpredictable.

That is the reason why nowadays the future of the economy is determined on assessment of the past, present and future, taking into account the uncertainties which are increasing daily, in both number and intensity. Moreover, of particular importance is the ability to understand and assess these uncertainties, and how they are transferred to the public. An additional problem is that practitioners face the challenge of unpredictability. Predicting the precise time and dynamics of instability in all these developments is very difficult, although it is possible to determine the factors that contribute to such instability.

Accordingly, macroeconomics may or may not be science or engineering, but it certainly has problems when trying to predict the future. Determining the probabilities is particularly difficult for rare, high influence precedents such as the current global economic crisis.

Because of such contradictions in the modern way of practicing macroeconomics, the main conclusion of this paper is contained in the following questions and answers of the perhaps the biggest economist in the world at this moment Gregory Mankiw (2006):

"Can engineers find adequate output solutions without adequate scientific basis? And at the same time, how good can scientific tenets be in terms of uncertainties and unresolved major problems facing the world economy? So, as the world generally needs scientists and engineers, it also needs macroeconomists of those two. They simply have to play both roles".

Dealing with the shocks in the economy would then be easier.

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**UDC 005.96:005.332.4(497.7)**  
**Professional paper**

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

**ACHIEVING SUSTAINED COMPETITIVE ADVANTAGE BY  
ENHANCING ORGANIZATIONAL DISTINCTIVE  
COMPETENCES**

**Abstract**

Drawing on the theoretical insights from the resource-based view of strategic human resources management, the purpose of this paper is to explore the potential of HR systems and their contribution to sustained competitive advantage by facilitating the development and utilization of organizational competencies. Specifically, we discuss, within an open-system framework, how HR activities, functions and processes may contribute to the development and utilization of organizational managerial, input-based, transformational and output based competencies.

The designated competencies contribute for the concept of sustainable competitive advantage in the context of two teoretical frameworks: environmental determinisam (which includes the microeconomic elements and industrial relations) and strategic selection (which includes economic and strategic choices).

Considering this theoretical framework, we conducted concrete empirical research in the companies in the Republic of Macedonia, collected relevant data and derived relevant findnings that can be applied in practice in order to achieve sustainable competitive advantage.

To the extent that the configuration of competency - enhancing HR activities, functions and processes depends on the unique and idiosyncratic capabilities for carrying out new combinations and insofar as such a configuration produces positive synergies for the firm, it may hold the potential of sustained competitive advantage.

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**Keywords:** *distinctive competencies, sustainable competitive advantage, strategic HRM*

**JEL classification:** O15; M21.

## Introduction

Distinctive competencies as a term was introduced for the first time to explain the leadership skills necessary for the successful transformation of the public organizations.<sup>1</sup> The concept is further expanded with emphasis on the internal organizational capabilities (strengths and weaknesses) and their adaptation to external threats and opportunities. Additionally, the concept is discussed as an integral component of corporate strategy, from which it follows that distinctive organizational competencies are essential for identifying and responding to the opportunities and the threats from the environment. Distinctive competencies are seen as a unique competitive position the company achieves by the effective development of the resources and an integral part of the organizational strategy. Achieving sustainable competitive advantage requires reinvestment in causally related organizational competencies, which are recognizable, complex and specific.<sup>2</sup>

Expanding the resource-based view, *Lado (1992)*<sup>3</sup>, proposed competence-based model for sustainable competitive advantage through the human resource management. This approach has seen the concept of sustainable competitive advantage in the context of two theoretical frameworks: determinism in the environment (which includes microeconomic elements and industrial relations) and strategic selection (which includes economic and strategic choices). Model I/O (Input/Output) recognizes the competitive advantage as the position of superior performances that the company achieves by offering products at lower prices and different products that customers are willing to pay a premium. This premise puts some pressure on the companies to which they must respond. Companies that successfully adapt to these

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<sup>1</sup> Selznik, (1957), "*Leadership and Administration*", Row, Evanston III

<sup>2</sup> Reed, R. and De Filippi, R. (1990), "*Causal ambiguity, barriers to imitation, and sustainable competitive advantage*", *Academy of Management Review*, vol. 15 no. 1, pp. 88-102

<sup>3</sup> Lado, A. A./Boyd, N. G./Wright, P. (1992): *A competency-based model of sustainable competitive advantage: Toward a conceptual integration*. In: *Journal of Management*, 18: 77-92.

industry/market requirements will survive and grow, while others will fail and exit the market.

## 1. Organizational competences

Systematic I/O model integrally connects four components of firms "distinctive competencies", such as managerial competencies and strategic focus, resource-based competencies, transformational-based competencies and output-based competencies.

### Managerial competencies and strategic focus

Broadly conceived, managerial competencies include: (1) the unique capabilities of organization's strategic leaders and (2) the unique ability to enact a beneficial firm -environment relationship.<sup>4</sup> Managerial values and competencies determine the strategic focus of the organization. Leaders create strategic vision, convey vision into organization and empower employees to realize the vision, so that strategic vision is realized through their reputation and support, which becomes the foundation on which unique competencies of the firm are built. The effective implementation of this vision depends crucially on the extent to which managers acquire and mobilize specialized strategic resources in a way that leads to superior performances relative to the competitors.

### Resource-based competencies

Resource-based competencies are consisted of human and nonhuman resources, tangible and intangible assets (physical resources, organizational capital resources, human resources, knowledge, skills and capabilities that enable a firm's transformational processes to create and deliver products and services that are valued by customers)<sup>5</sup>, which allows the organization to lead competing firms in a certain time period. Achieving sustained competitive advantage depends upon the firm's

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<sup>4</sup> Hambrick, D.C. & Mason, P.A. (1984), "Upper echelons: The organization as a reflection of its top managers", *Academy of Management Review*, 9:193-206

<sup>5</sup> Lado, A., & Wilson, M., (1994), "Human Resource Systems and Sustained Competitive Advantage: A Competency-Based Perspective", *Academy of Management Review*, 19, pp. 699-727

ability to utilize existing stocks of resources and its ability to accumulate new resource stocks more efficiently and effectively relative to the competitors.<sup>6</sup> Resource-based competencies suggest synergistic interactions between transformational-based and output-based competencies. Resource-based competencies in order to become a source of sustainable competitive advantage must be causally related and should demonstrate complex relationships with other specific resources and competencies of the organization. The significance of intangible, input/resource-based competencies will increase the difficulty of their imitation by the competitors.

Acquisition and mobilization of resources-based competencies that potentially generate sustained competitive advantage, not only requires managerial competencies in collecting information, but also encourages expectations of future earnings from these resources. Thus, the company that owns unique skills and capabilities earns above normal return on investment by purchasing resources that are undervalued on the market and using these resources to implement the strategy or by not buying resources that are overvalued on the market.

### **Transformational-based competencies**

Transformational-based competencies can be considered as an organizational capabilities that are necessary to convert inputs into outputs.<sup>7</sup> Transformational-based competencies are closely related to the concept of "value chain", developed by McKinsey and adapted as an analytical tool for the strategic management.<sup>8</sup> Transformational-based competencies can include innovation, entrepreneurship and organizational culture. Innovation (including technology, marketing, managerial) allows the organization to generate new products/processes more quickly than the competitors. Organizational culture can increase capacity for organizational learning and adaptation. I/O-based model suggests that firms can achieve competitive advantage with lower costs through learning effects, economies of scale, economy of size and capital/labor substitution.

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<sup>6</sup> Hammel, G. and Prahalad, C. K., (1990), "*The Core Competence of the Corporation*", Harvard Business Review, (68), pp. 79-91

<sup>7</sup> Lado, A.A., Boyd, N.G.& Wright, P (1992), *A competency based model of sustainable competitive advantage: Towards a conceptual integration*, Journal of Management, 18:77-91

<sup>8</sup> Porter, M (1985), "*Competitive advantage*", New York, Free Press, pp.15

The effects of learning usually result in repetition of activities that leads to greater learning and efficiency in production. Economics of scale results in lower costs by expansion of the capacities. Economics of size results from sharing resources among organizational units. For the organizational culture represent sustainable competitive advantage should be valuable, rare and difficult to imitate by competitors. Capital/labor substitution involves replacing one another, in order to increase efficiency. Strong organizational culture relieves human creative potential to generate a continuous flow of ideas that can be translated into new products and processes.

### **Output based competencies**

Output-based competencies do not refer only to the physical outputs that deliver value to the customers, but also to the invisible outputs, such as the reputation of products and services, quality, brand and distribution channels that provide value to customers. Long-term survival and growth of the firm largely depends on how well the value is delivered to the customers. The relationship between output-based competencies and environment is unique competence that leads to creating value for consumers and consequently can generate sustainable competitive advantage for the firm.<sup>9</sup>

I/O paradigm conventionally focuses on the relative market share and profitability as measures of the organizational performances that serves as an indicators of the strategic advantage. Accordingly, larger market share allows the firm superior return of the investment compared to the competitors. However, in order to market share became a source of competitive advantage, it must be acquired in a way that is not easily imitated by competitors, and is stable, with defined boundaries. To achieve sustainable competitive advantage, companies, among others, must deliver value through service, quality and confidence.

The current reputation of the firm is a result of its previous relationships with customers, dealers, suppliers and other stakeholders. The current quality of relationship with them is the basis for future reputation and its building should be a priority of senior management in achieving sustainable competitive advantage.

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<sup>9</sup> Barney, J.B., (1991), "Firms' Resources and Sustained Competitive Advantage", *Journal of Management*, 17, pp. 99-120

Considering this background, it is strongly required to implement a competency-based approach to the human resources development to help ensure a successful deployment of a workforce enhancement and support business growth strategies.

## **2. Research methodology**

Taking into account the before mentioned facts, we conducted research in 45 companies from the private sector in Republic of Macedonia<sup>10</sup>, where it is noticed an explicit and formal use of strategic human resource management practices.<sup>11</sup> We have collected relevant data, using 1) metric checked and standardized instruments, 2) we have conducted an analysis of the degree of strategic competitiveness of a certain number of organizations, 3) we have made an attempt of action towards implementation on strategic systems of practices in the organizations, 4) attempt to raise the level of awareness among managers and employees for the importance of application of configurations of the strategic HRM practices for achieving strategic competitiveness of the organizations. Data collections have been done through the administration of structured questionnaires to a managers in the selected companies.

This approach provides to be collected relevant data that can be applied in practice in order to achieve sustainable competitive advantage. Concrete empirical research incorporates contents in the field of strategic HRM and it is from an interdisciplinary character.

The research is based on an analytical descriptive methodology, which aims to select relevant information for the components and determinants of strategic systems of HRM practices, based on the competencies that through the application in the companies will respond to the essential questions in the research. Conventional descriptive

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<sup>10</sup> Specified research was conduct during the period: September 2010 - May 2011 and it is a part of the doctoral dissertacion: E. Tosheva „*Configurational approach to the strategic HRM and its influence of the sustainable competitive advantage*“- Institute of Economics – Skopje, 2011, pp192-234.

<sup>11</sup> Organizations that satisfy these criteria were select from the Macedonian register of the companies and they are industrial and service companies, which are qualified as significant competitors in their field and having developed proactive, formal strategic human resource management practices. Analyzed companies are from various sectors such as telecommunications, banking, the electricity sector, tourism and catering, trade sector, food production, IT, consulting and insurance sector.

research and used quantitative methodology result in qualitative findings detailed in the concluding observations in this paper.

Although we do not stand firmly at the position that the function of human resources is the only way of developing and utilizing competencies, we submit the following propositions concerning the relative competitive advantage of companies that apply the systems for HR to increase the organizational distinctive competencies.

**Proposition 1:** Companies with HR systems that facilitate the development and exploitation of managerial, input based, transformational and output based organizational competencies will have a greater probability of achieving competitive advantage than companies that have HR systems that prevent the development and exploitation of competencies.

**Proposition 2:** Companies with configurations for competencies enhancing HR systems which have attributes that are unique, causally related and synergistic will achieve sustained competitive advantage compared to the companies whose HR system configurations are typical, causally unrelated and nonsynergistic.

**Proposition 3:** Companies with HR systems that are reciprocally integrated with their strategic suprasystems will be more effective in the developing and utilizing organizational competencies (and thereby in achieving sustainable competitive advantage), relative to the companies whose HR systems are sequentially connected or separated from its strategic suprasystems.

**Proposition 4:** Companies with self-renewing HR processes are more likely to generate higher levels of competencies (and therefore more likely to achieve greater levels of sustainable competitive advantage) than companies whose HR processes are self-maintaining.

In our research, we concluded that the strategic usage of HRM practices for competency enhancing entails the use of certain practices in the various areas of HRM (recruitment, training, performance evaluation and design of the work). Thus, we have been analyzing the influence of the following strategic HRM practices: employee involvement in training, the existence of the objectives of the training programs, the existence of long-term budgets for training, a comprehensive system for

recruiting staff, the usage of performance appraisal systems, the determination of earnings depending on performances, developmentally based assessment, internal and external promotions based on performance assessment, design of the work according to the skills of individual employees, teamwork and employee participation in decision-making program.

Considering strategic use of human resources management practices, we conclude that the practices used in organizations in the Republic of Macedonia were select for the foreseen managerial approach. Or, by saying in other words, the variation of shared set of practices for human resources management could represent latent, determined architecture, philosophy or character, which connects each set of practices for human resources management.<sup>12</sup>

The research introduces measures for perceived organizational competitiveness (PPOKP) and perceived organizational market competitiveness (PPOPMP) in order to correlate positively (with the moderate and strong associations) with the objective measures of the competitive advantage of the companies.

### **3. Results from the research**

By applying a regression analysis (multiple linear regressive model) of the statistical data are obtained following tabular and graphical reports.

In a case that dependent variable is a perception of the presumed organizational competitive advantage, and all the other variables included in the model are independent then we received the following Table:

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<sup>12</sup> Dollinger, M J & Golden, P.A,(1992) "*Interorganizational and Collective Strategies in Small Firms: Environmental Effects and Performance*" *Journal of Management*, 18(4):695-715; Powel, T. C. (1992), "*Organizational Aligment as Competitive Advantage*", *Strategic Management Journal*, 13:119-154

**Table 1. Indicators of regressive model**

**Model Summary(b)**

	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.732(a)	.535	.270	.44668	.535	2.017	16	28	.050	2.100

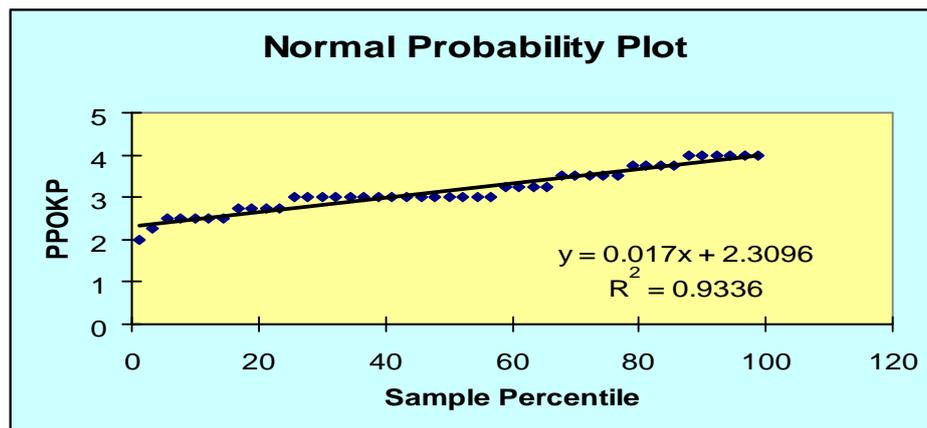
a Predictors: (Constant), MVPZ, OKI, EOY, OZZP, PPVO, VVO, NEN, PCPO, TR, RBP, SPP, VPBPP, DBO, VEN, DRVPV, SSRK

b Dependent Variable: PPOKP

The coefficient of multiple correlation value is 0.732, which means that there is a strong correlation between the observed independent phenomena and the perception of the presumed organizational competitive advantage.

]The coefficient of determination indicates that 53.50% of the changes in perception of the presumed organizational competitive advantage result from the changes of the defined independent variables included in the regressive model. This interaction is a statistically significant as illustrated in significant value of F, as a realized risk level of error.

**Figure 1. Trend line of the dependent variable PPOKP depending on the answers, or the values of the independent variables**



From the above graphical presentation can be seen the developmental tendency of changing perception of the presumed organizational competitive advantage depending on the respondents' answers, i.e, the values that receive independent variables, with the expressed significant value of the coefficient of determination.

In a case that dependent variable is a perception of the perceived organizational market competitive advantage, and all the other variables included in the model are independent, then we received the following results:

**Table 2. Indicators of regressive model**

Model Summary <sup>a</sup>										
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.605 <sup>b</sup>	.366	.004	.51350	.366	1.010	16	28	.475	1.824

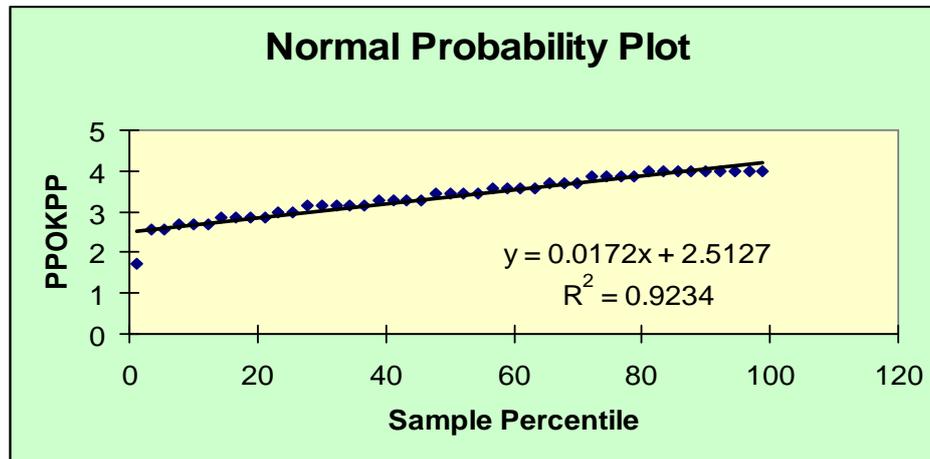
a. Predictors: (Constant), MVPZ, OKI, EOY, OZZP, PPVO, VVO, NEN, PCPO, TR, RBP, SPP, VPBPP, DBO, VEN, DRVPV, SSRK

b. Dependent Variable: PPOKPP

The coefficient of multiple correlation value is 0,605, which means that there is a strong correlation between the observed independent phenomena and the perception of the presumed organizational market competitive advantage.

]The coefficient of determination indicates that 36,6% of the changes in perception of the presumed organizational market competitive advantage result from the changes of the defined independent variables included in the regressive model. This interaction is a statistically significant as illustrated in significant value of F, as a realized risk level of error.

**Figure 2. Trend line of the dependent variable PPOPKP depending on the answers, or the values of the independent variables**



From the above graphical presentation can be seen the developmental tendency of changing perception of the presumed organizational market competitive advantage depending on the respondents' answers, ie, the values that receive independent variables, with the expressed significant value of the coefficient of determination.

#### 4. Conclusion

Based of the previous observations, we derive the following conclusions:

1. Organizational competencies must be continuously replenished, upgraded and deployed in order for the company to gain and retain competitive advantage. Organizational competencies may be expanded, upgraded and maintained through HR systems that emphasize hiring employees for the organization as a whole, extensive socialization of newly hired employees, development of a system for performance appraisal, competency based compensation strategy and comprehensive training and development to provide competencies that are needed to achieve long run productivity.

2. Further, the configurations of these HR practices may generate positive synergies and engender complex interactions among distinctive competencies of the firm's employees and other organizational resources that can not be imitated by competitors. Thus, the sustainability of HR-based competitive advantage may depend on the nature of the configurations and attributes of the HRM systems.
3. Companies with HR systems that are reciprocally integrated with their strategic suprasystems will likely achieve superior long-run performances relative to the companies that either lack such an integration or that manage human resources primarily as a means to solve competitive issues.
4. Furthermore, the sustainability of HR-based competitive advantage may depend on the nature of the HR processes entailed in the accumulation, development and deployment of organizational competencies towards self-renewing processes

By emphasizing processes for developing and utilizing firm specific, causally connected competencies, this paper contributes to the expanding of the behavioral perspective of the strategic human resource management, which emphasizes the emerging role of employees as the basis for creating sustainable competitive advantage. To the extent that the configurations of the competency-enhancing HR activities, functions and processes depends of the unique and idiosyncratic capabilities, implies that such of configurations produce positive synergies for the company and lead to sustainable competitive advantage. The designated competencies contribute for the concept of sustainable competitive advantage in the context of two theoretical frameworks: environmental determinism (which includes the microeconomic elements and industrial relations) and strategic selection (which includes economic and strategic choices).

We realise that conditions in the firm's external and internal environment may enable or constrain the capacity of HR systems to develop and exploit organizational distinctive competencies. Achieving a sustainable competitive advantage through firm's specific competencies will require continuous monitoring by the firm because competency patterns may change over time. Thus, managers may need to continuously question and reexamine their assumptions regarding what constitutes a distinctive competence for their firms.

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**UDC 336.71:281:005.52:005.334**  
**Professional paper**

**Gule GULEV \***)

## **REGULATION OF THE OPERATIONAL RISK IN ISLAMIC BANKING**

### **Abstract**

The general overview of the global regulatory treatment and characteristics of the operational risk in Islamic banking and its similarities and differences with the operational risk in conventional banking is one of the aspects of Islamic banking which will be interesting theme for research in the next years.

The operational risk can not be avoided in the business activities of the Islamic banks and therefore the operational risk management is important function in Islamic bank. This is especially about issues related to compliance with Shari`ah rules and principles and the capital requirements for operational risks which arise from priority of use of the Shari`ah Law in Islamic banking operations and risk management.

The establishing of international organization for Islamic finance in the 90s of XX century was the first step to achieve higher level of standardization in use of Islamic banking products and services in compliance with Shari`ah and set up common prudential standard for risk management systems and controls. In this direction are also the rules and principles prescribed from the Islamic Financial Services Board in a role of a central body for regulation of operational risk management in Islamic banks.

**Key words:** operational risk, Shari`ah law, regulation, Islamic bank, Islamic finance.

**JEL classification:**G 21, G28, G29, Z12.

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## 1. The position of Islamic banking in the new financial architecture

Islamic banking is part of the broader concept of Islamic finance. The Islamic banks are financial intermediaries that operate in accordance with the Shari`ah principles, and there exists a ban (prohibition) for the banks to work with interest (*Riba*); the financial contracts should not contain provisions which introduce uncertainty (*Gharar*); prohibition to finance gambling (*Maysir*); the earnings should not derive from economic activities related to financing of pornography, alcohol, tobacco, weapon trafficking (*Haram*); each financial transaction should be measurable and there should be a possibility to identify the funds, and, the parties within the financial transactions must share the risk and the profit.<sup>1</sup>

Islamic banking is generally widespread in countries with predominantly Muslim population in Asia and Africa, where the big international banks as well are trying to take market share<sup>2</sup>. However, it is often seen in non-Muslim countries as well,<sup>3</sup> and, within the creation of conditions for attracting Islamic banks, Great Britain is the leading country, which pretends to grow up into a centre of Islamic finance and trade through the bank regulation changes that Great Britain makes, to provide place for the Islamic finance products at the market.<sup>4</sup>

Today, the Islamic banking is in continuous development no matter of the conventional banking system suffer from crisis. In the world, there are 325 Islamic banks, two of them are in Australia, six of them are on Bahamas, 38 in USA, there is one Islamic bank in Denmark, one in France and one in Ireland, in Germany and Switzerland operate five Islamic banks per country, and 23 Islamic banks are in Great Britain, there are four of them in Luxemburg, and according to the Islamic

<sup>1</sup> Hylmun Izhar, Identifying Operational Risk Exposures in Islamic Banking, (2010), Kyoto Bulletin of Islamic Area Studies 3-2 p.20

<sup>2</sup> Some of the leading banks has their own representative offices in Muslim countries where, through the Islamic windows, offer to their clients banking products acceptable for the Islamic banking: (e.g. USA: Citibank, JP Morgan/Chase, Goldman Satche i UBS Warburg; Great Britain: HSBC, Barclays Capital, ANZ Grindlays Bank; Netherlands: ABN Amro; France: BNP Paribas, Societe Generale; Germany: Commerzbank i Deutsche Bank; Japan: Nomura Securities; Switzerland: UBS).

<sup>3</sup>The Arabic banking corporation has offices in: Frankfurt, London, Milano, New York, Paris, Sao Paolo, Stockholm, Moscow. ABC (Arab Banking Corporation)

<http://www.arabbanking.com/world/IslamicBank/En/Products/Pages/CommercialBanking.aspx>

<sup>4</sup> Uhomoi bhi Toni Aburime, Felix Alio, Islamic Banking: Theories, Practices and Insights For Nigeria, International Review of Business Research Papers Vol.5 No. 1 January 2009 Pp. 324.

financial principles, in South-east Europe, operates one Islamic bank in Bosnia and Herzegovina.<sup>5</sup> Some estimates show that more than 250 financial institutions in more than 45 countries, operate with Islamic finances, and the industry has growth of more than 15% per year in the last five years. The annual turnover of the market is estimated at \$ 350 billion, compared to the \$ 5 billion in 1985.<sup>6</sup>

Facts that show the seriousness of the Islamic finance and Islamic banking are the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions(AAOIFI) in 1991,<sup>7</sup> than the establishment of Dow Jones Islamic Market<sup>8</sup> in 1999, to offer investment portfolios in accordance to the Shari`ah law, in 2003 starts working the Islamic Financial Services Board and in 2005 starts working The Islamic International Rating Agency (IIRA),<sup>9</sup> so, we can say that the Islamic banking grows up into key player in the international finance.

## **2. Treatment of operational risk in Islamic banking**

Consideration of the operational risk in Islamic banking and its regulatory treatment, is without intention to go into a detailed contemplation and explanation of the operational risk within the individual financial instruments and contracts, but there will be made some attempts to create general overview of the global regulatory treatment and characteristics of the operational risk in Islamic banking and its similarities and differences with the operational risk in conventional banking.

In that direction, as we can see in the above mentioned researches, the operational risk can not be avoid in the business activities of the Islamic banks. Moreover, some researchers argue that the Islamic banks are on impact of many operational risks which are different of those from which suffer the conventional banks. These statements are based on the arguments that the Islamic banks operations are not fully

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<sup>5</sup> Bosna Bank International, Sarajevo, Bosnia and Herzegovina. <http://bbibanka.com.ba>

<sup>6</sup> Mohamed Helmy, Risk management in Islamic banks, (2012), ESLSCA Business School, MPRA Paper No. 38706, p.7. <http://mpra.ub.uni-muenchen.de/38706>

<sup>7</sup> Accounting and Auditing Organization for Islamic Financial Institutions(AAOIFI), <http://www.aaofi.com/aaofi/Home/tabid/36/language/en-US/Default.aspx>

<sup>8</sup> Dow Jones Islamic Market™ Index <http://www.djindexes.com/Islamicmarket/>

<sup>9</sup> The Islamic International Rating Agency (IIRA), <http://www.iirating.com/Default.aspx>

standardized and there is a possibility, different banks to execute them in different ways. Another argument is the complexity and variety of Islamic bank products and services, as well as the fact that they are relatively new at the financial market. All above mentioned, together with the fiduciary responsibility of the Islamic bank show that the operational risk is the most important for the Islamic bank.<sup>10</sup> There is one thing more which can contribute to brighter exposure of the Islamic banks on operational risk, which is the necessity of compliance of the regulation for Islamic financial products with the regulation for conventional financial markets. That is undoubtedly big and complex work.

Therefore, the operational risk on which are exposed the Islamic banks in accordance with some authors can be divided into three categories<sup>11</sup> as the following:

- operational risks which are result of different types of bank activities, and can be sometimes similar with the activities of all financial intermediors, no matter whether they are in compliance with the Shari`ah principles or not.
- risk of compliance with the Shari`ah principles which is related to the potential incompliance with the Shari`ah rules and principles within the banking operations, as well as the risks related to the fiduciary responsibility of the Islamic bank as entrepreneur in the case of failure or negligence while investing, which are responsibility of bank and become its obligation.
- legal risk which derives from Islamic bank operations or problems related to the legal uncertainty in interpretation and execution of the contracts that are in compliance with the Shari`ah principles.

From here we can see that it is considered that the Islamic banks are exposed to regular operational risks as any other conventional bank, but they are also exposed to two additional groups of risks which can be classified as operational risks, which arise from the Shari`ah rules and principles.

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<sup>10</sup> Farhad Reyazat, *Risk Management Framework in Islamic Banking: Basel II and III, Challenges and Implications in Islamic Banking*, (2012), Money and Economy, Vol. 6, No. 2, Monetary and Banking Research Institute, Islamic Republic of Iran. p.78.

<sup>11</sup> Abdullah Marliana, Shahimi Shahida, Ismail Abdul Ghafar, *Operational in Islamic Banks: Issues and Management*, (2011), Persidangan Kebangsaan Ekonomi Malaysia ke VI (PERKEM VI), PROSIDING PERKEM VI, JILID 1 ISSN: 2231-962X, p.255

In the world of Islamic banking and Islamic finances, the regulatory role has the Islamic Financial Services Board<sup>12</sup> with its publications in which are set standards and principles for the operational risk and the Islamic banks.

The international regulatory treatment of the operational risk for Islamic financial institutions and Islamic banks, starts in 2005, with the publishing of Guiding Principles of Risk Management for Institutions (other than insurance institutions) offering only Islamic Financial Services<sup>13</sup>, and this was the first step to formal introducing the severity of operational risk in Islamic banking.

Within the principle number seven dedicated to the operational risk, are given the basics for establishing appropriate systems and controls for operational risk in Islamic banks as well as the definition of operational risk and fiduciary responsibility of the Islamic banks.

The definition of operational risk in Islamic banking is in compliance with the basics on which the Islamic economy has been established/introduced. Although, at the first side, the definition about the operational risk seems identical with the definition given in Basel 2, dedicated to the conventional banking, there is also an essential difference.

Namely, the definition about the operational risk<sup>14</sup> in Islamic banking, says that it is a risk related to inappropriate or bad internal processes, people or systems or external events, but together with two additional elements which the potential losses connect to the incompliance with Shari`ah and failures in the fiduciary responsibility. Therefrom, we can remark that within the definition about the operational risk there are concluded the legal risk, and the reputational risk as well.

Paying attention to the elements which are specific for the operational risk in Islamic banking, the focus will be the incompliance with the Shari`ah rules and principles, and the fiduciary risk, legal risk, people risk and technology risk as well.

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<sup>12</sup> The Islamic Financial Services Board (IFSB)), which starts operating in 2003, is international organization for establishing standards that promote and enhance the soundness and stability of the Islamic financial institutions, through issuing prudential standards and principles for Islamic banking, capital markets and insurance. IFSB conduct surveys and coordinate initiative related to financial islamic industry and organizes seminars, conferences for the authority and the industry.  
<http://www.ifsb.org/>

<sup>13</sup> Guiding Principles of Risk Management for Institutions (other than insurance institutions) offering only Islamic Financial Services, Islamic Financial Services Board,2005.

<sup>14</sup>Guiding Principles of Risk Management for Institutions (other than insurance institutions) offering only Islamic Financial Services, Islamic Financial Services Board, december 2005, p.26.

In Islamic banking, the compliance risk with Shari`ah principles is considered as the greatest priority no matter what other operational risks are identified. This risk appears when the Islamic bank will not compliance its activities, products and services with the Shari`ah rules and principles defined from the Shari`ah Board or the Authority. When the Islamic bank operates on a territory where does not exist central body as Shari`ah Board, the Islamic bank establishes its own Shari`ah Board or engages a person that is familiar with Shari`ah, and in accordance with that person's opinions, the bank compliance its activities, products and services i.e. this Shari`ah Board additionally assess/evaluates the activities, products and services of the Islamic bank and gives consent for its use.<sup>15</sup> The establishment of this type of body within the Islamic bank and its operation are subject to evaluation in accordance with predetermined rules.<sup>16</sup> If the Islamic bank does not proceed this compliance, the transactions might be canceled, and the income would be considered as illegitimate.

The greatest importance of the compliance with Shari`ah principles and rules is due to the fact that the majority of clients that use Islamic bank services, does that because of principles related to the Islam and their perception about the compliance of the bank operation with the Shari`ah rules. If this perception is unsettled, this will make negative impact to the reputation of the bank in public and to the deduction of the bank income due to the reduction of the number of clients and their calling out funds of the bank accounts.

Second important element which is specific within the definition about the operational risk in Islamic banking, is the fiduciary risk which arises as a result of the Islamic bank failures to work in accordance with the standards which are applied for its fiduciary responsibility. In this case, using the funds of the investment and other accounts through which the bank executes its investment function and project financing, the Islamic bank will not realize profit or due to insufficient concern in the process of managing the funds, the bank will suffer losses which will disturb its liquidity and solvency. Due to avoid this type of situations or to decrease the probability of its arise, the Islamic bank should introduce

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<sup>15</sup> Declaration adopted by Shari`ah Supervisory Board of the Abu Dhabi Commercial Bank for its bank product which is available on: [http://www.adcb.com/Images/AmbitionEducation\\_tcm20-31925.pdf](http://www.adcb.com/Images/AmbitionEducation_tcm20-31925.pdf)

<sup>16</sup> Guiding Principles in *Shari`Ah* Governance Systems for Institutions offering Islamic Financial Service, Islamic Financial Services Board, December 2009.

clear and formal policies for undertaking those different and potentially conflict roles while managing different types of investment accounts.

These two types of risks, the risk of compliance with Shari`ah principles and the fiduciary risk are considered as serious treat for the Islamic bank because this can lead to decreasing the number of clients what will result in: decreasing the profitability, withdrawel of funds, loss of other incomes, unfulfillment of the financial obligations, damage to the reputation of the bank, and limitation of the Islamic bank business possibilities.

The legal risk arises of various reasons related to unstandardized practices for execute and interpretation of different contracts in different states, the insufficient number of legal experts in this area, the legal ground of the Islamic financial instruments in some countries, as well as incompliance with the changes of the laws and other regulation.

Additionally, the lack of Central regulation body with sufficient authority to define and control the Shari`ah principles, is one of the reasons which lead to different use of the rules for financial statements, revision and accounting in Islamic banks. There should not be put aside the oppinions that some of the operational aspects of the Islamic bank activities are insufficiently covered with legal regulation which leads to higher legal risk exposure in Islamic banking. Therefore, it is considered that the impact of the legal risk over the Islamic banking is important and cannot be ignored.<sup>17</sup>

Risk of people has braighter context in Islamic banking rather than in conventional banking. The reasons for this are particularly in the characteristics of the Islamic financial intruments and the operation principles related to the Shari`ah, but also in the environment where the Islamic banks operate. In Islamic banking, the staff must recognize and understand the financial products and services in Islamic banking as well as the financial products and services of the conventional banking. This requirement limits the number of quality staff that can be in short term employed in the Islamic bank, and this also increases the possibility of mistakes, frauds, incompliance with the Shari`ah principles and other types of failures, intentional or unintentional, and increases the exposure on operational risk.

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<sup>17</sup> Hylmun Izhar, Identifying Operational Risk Exposures in Islamic Banking, (2010),Kyoto Bulletin of Islamic Area Studies 3-2, p.28

From aspect of the environment, there is a necessity in Islamic bank industry to be developed through innovators, risk managers, regulators and supervisors that have knowledge in modern finances and understand the principles of Shari`ah i.e. the Islamic law on financial transactions. The lack of trained people has been already recognized as a problem and there are founded institutions which offer training programmes in Islamic banking and Islamic finances. In Europe, precisely in London, Great Britain, operates Institute of Islamic Banking and Insurance<sup>18</sup> which offers training programmes, conferences and seminars, lecturers and publications for Islamic finance and Islamic banking. This Institute also promotes the document entitled: 'Moral Code of Conduct in Islamic Finance'<sup>19</sup>, for every person that wants to work in Islamic banking. They make reference to the Dutch banking code, where each member of the Board of directors of the Dutch bank NIBC, has signed moral and ethic declaration.<sup>20</sup> With this approach, they hope to educate staff capable of creating financial innovations in accordance with the requests of the clients, and at the same time they will not include interest and are going to be in compliance with the other Shari`ah rules.

If the Islamic banks want to be competitive with the conventional banks at the international markets, their future operations will more depend on the technology, so, the technological risk will become more important for the Islamic banks risk management. If the Islamic bank does not want or is not capable of following the technological development in the banking operations, the Islam bank will be far behind its competitors. Hence, the use of technology within the bank operations arise the possibility or likely hood of supervening events related to the operational risks and risks from the information technology. Therefore, each Islamic bank should upgrade and test the soundness and stability of its system, to be able of offering new products and services to the clients, in accordance with Shari`ah principles, to follow the market trends and to comply with the regulatory changes as well as to provide the necessity of more information and knowledge in the Islamic bank management.

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<sup>18</sup> Institute of Islamic Banking and Insurance (IIBI), <http://www.Islamic-banking.com/>

<sup>19</sup> Recommendation for a 'Moral Code of Conduct in Islamic Finance', 4th International Annual Thematic Workshop – 'Legal Compliance versus Moral Responsibility in Islamic Finance', 2012  
[http://www.Islamic-banking.com/resources/2/Moral%20Code%20of%20Conduct%20-%20IIBI\\_ISRA%20-%20draft%20\\_10%2009%202012\\_.pdf](http://www.Islamic-banking.com/resources/2/Moral%20Code%20of%20Conduct%20-%20IIBI_ISRA%20-%20draft%20_10%2009%202012_.pdf)

<sup>20</sup> NIBC Bank - Nederland, <http://www.nibc.com/en/about-nibc/corporate-governance/moral-and-ethical-conduct-declaration.html>

### 3. Management of operational risk in Islamic banking

The operational risk management in Islamic banking has the same or similar characteristics as the operational risk management in conventional banking. In Islamic banking exist two level of operational risk management as well:

- micro level where the Islamic bank as financial institution manages itself its operational risk events and operational risk profile, and
- macro level where the competent authority or bank supervisory authority prescribes general rules for establishing systems and controls for the operational risk management within the Islamic banks, and in the Islamic banking system as whole.

The specifics of the operational risk management in Islamic banking determine the scope, the content and the requirements about written policies, procedures and processes for identification, measurement, monitoring and control of the operational risk. However, the final objective is identical as it is in the conventional banking and it should help in the processes of decision making for accepting, avoiding or reducing the operational risk which the Islamic banks are faced.

One of the most important requirements for the Islamic banks related to the operational risk management is a compliance of its activities, products and services with the Shari`ah principles. If the Islamic bank fails to achieve this compliance, it would be potential danger for the bank income and the reputation. For those reasons, the Islamic Financial Services Board recommends to the Islamic banks, in its stress testing programmes, to put in different aspects of risk of incompliance with the Shari`ah rules and principles.<sup>21</sup>

This approach assumes that the Islamic bank should be capable of quantifying in its own stress testing programmes, according defined scenarios, the potential losses from failures of compliance of the specific products or activities, and to evaluate whether the business continuity plans are in function of effective risk management raised from Shari`ah incompliance.

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<sup>21</sup> Principle 3.15, Guiding Principles on Stress Testing for Institutions offering Islamic Financial Services [excluding Islamic Insurance (*takaful*) Institutions and Islamic collective Investment schemes], IFSB-13, Islamic Financial Services Board, 2012, p.37.

Additionally, the Islamic bank, as part of the stress testing, should evaluate the financial implications from any impact to the bank reputation as result of significant failures in compliance with the Shari`ah principles. The recommended stress test programmes should be adequate with the scope, the complexity and the nature of the bank operations. In this direction, it is recommended the smaller Islamic banks to have more simple stress testing programmes with lower level of technical approach which is more focused to qualitative aspects, although, the bank management board has the opinion that they are very well familiar with the risk profile of the bank.

In the case of Islamic banks with complex structure and scope of activities, it is recommended to execute stress testing with more complex scenarios with qualitative and quantitative aspects which will include more business lines and geographic regions where the bank has its own operations.

#### **4. Conclusion**

The approach to treatment of operational risk in Islamic banking is not that different than conventional banking. In Islamic banks there exist systems and controls, and written policies, procedures and processes for operational risk management.

Islamic banks are also profitable financial organizations although their operational environment is determined with religious principles from Shari`ah Law. This situation in some cases is advantage but in the world where conventional banks dominate, it's not easy to achieve sufficient strength for competitive run.

Islamic banks are subjects of same or similar risk as other financial institutions and risk management is one of the most important functions of any Islamic bank. Due to their specifics related to Shari`ah principles and rules, they are more vulnerable to operational risk and operational risk management in Islamic banks is still a challenging task.

Main reasons for that is a lack of standardization of banking products and services and fiduciary responsibility and lack of central competent authority for interpretation of Shari`ah rules and principles in the context of use of this products and services. This is significant potential operational risk because, in any moment, it allows some individual bank Shari`ah Board to declare them as illegitimate. In this

context is also the legal risk through interpretation of Islamic financial contracts as well as use of informational technology in banking operations as technology risk and people risk through limited possibilities for training the employees in Islamic banks.

In the last decade, the regulation and capital requirements for operational risk are subject of documents issued from Islamic Financial Services Board which are in accordance with the documents issued from Basel Committee of Banking Supervision but complied with Shari`ah. These documents represent improvement in operational risk management because it is a step forward to achieve standardization in implementation of prudential standards as preconditions to avoid or reduce operational risk events. The acceptance of this recommendations from Islamic bank, will get over the weaknesses in the treatment of operational risk event in different Islamic banks in different jurisdictions.

The process of consolidation on international Islamic financial institutions with authority to regulate some issues in banking will contribute to the better understanding of complexity and nature of operational risk in Islamic banking, and the constant growth of Islamic banking will impose obligation for most efficient operational risk management.

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**THE UNEMPLOYMENT, POVERTY AND SOCIAL EXCLUSION  
IN THE REPUBLIC OF MACEDONIA**

**Abstract**

The paper addresses the unemployment, poverty and social exclusion in the Republic of Macedonia. In that context, theoretical aspects and definitions of poverty, the relation and interaction between the unemployment, poverty and social exclusion, as well as the strategies and measures for decrease of poverty and social exclusion, are elaborated. According the available data, the unemployment rate in the country in 2011 was 31.4%, while the poverty rate 30.4%. This means that approximately three of every ten citizens in the country are living under the poverty line, which is determined on 70% of the average annual incomes of the households. These indicators are showing that the country is facing with big poverty, which as a consequence has increase of the number of socially excluded persons. The policies, measures and activities which are defined in the National strategy on alleviation of poverty and social exclusion in the Republic of Macedonia 2010-2020, are of great importance in the process of decreasing the poverty and the number of socially excluded persons. Consequently, it will lead to higher standard of living and better quality life.

**Keywords:** unemployment, poverty, poverty rate, social exclusion, social policy

**JEL classification: J64, I30, I32, I38**

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## **Introduction**

The year 2010 has been designated as the European year for combating poverty and social exclusion. The goals of the European year for combating poverty and social exclusion cover four broad objectives and guiding principles:<sup>1</sup>

- a recognition of rights for all people, but especially those in a situation of poverty and social exclusion, to live in dignity and take part in society;
- a shared responsibility and participation, emphasizing both collective and individual responsibilities in the fight against poverty and social exclusion;
- promoting cohesion, emphasizing the benefits for all society of an eradication in poverty and greater social inclusion, and;
- establishing commitment for concrete action for the eradication of poverty and social exclusion at all levels of governance.

However, deep-rooted disadvantages faced by certain groups of society, coupled with ingrained attitudes and beliefs of others, means that legislation alone is unlikely to achieve the goal of creating a society which genuinely offers equal opportunities to all and is totally free from discrimination. Despite legislation, inequalities still exist in terms of gender, race or ethnic origin, religion or belief, disability, age or sexual orientation, and social exclusion tends to perpetuate itself in a cycle of deprivation from one generation to the next. These inequalities manifest themselves across many aspects of daily life, such as education, the workplace, healthcare, or in terms of access to goods and services of general interest.<sup>2</sup>

The aim of this paper is to identify the interaction between the unemployment, poverty and social exclusion in the Republic of Macedonia. The analysis would be focused on relevant aspects of the unemployment, and its influence on the increase of poverty and social exclusion. Relevant to this, main strategic purpose and separate goals of the National strategy on alleviation of poverty and social exclusion in the Republic of Macedonia 2010-2020 will be observed, including the measures which are necessary to be taken, in order to decrease the number of poor and socially excluded persons.

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<sup>1</sup> Decision No. 1098/2008/EC

<sup>2</sup> European Commission, Eurostat Statistical Books, Combating poverty and social exclusion - A statistical portrait of the European Union 2010, Brussels, 2010, p.6

The analysis in the paper is referring to the data for the unemployment, poverty and social exclusion in the Republic of Macedonia for the period 2003-2011, as well as on the strategic documents from the Ministry of Labor and Social Policy, which are dealing with the alleviation of poverty and social exclusion in the country.

### **1. Theoretical aspects and definitions of poverty, social exclusion and unemployment**

The poverty, social exclusion and unemployment influence each other, thus creating a spiral of insecurity, which ends in multiple deprivations. Deprivation usually begins with the loss of employment, which in turn leads to a significant degradation in living standards, that is, increased risk of poverty. Living in poverty creates additional difficulties in the search for employment and contributes to a long-term unemployment trap for many individuals. At the same time, unemployment and poverty inhibit participation in social activities. Due to the lack of money and to the stigmatization that can be caused by unemployment, social ties are weakened, increasing the probability of social isolation. In turn, the social isolation has an adverse effect on employment, since the individuals concerned are isolated from sources of information and lack the support needed for employment search.

Social exclusion is understood first and foremost as exclusion from the labour market. If social exclusion is conceived primarily as exclusion from the labour market, in other words, if employment is a precondition for inclusion, then education is one of the key mechanisms of social inclusion. The degree of employability is connected with the possession of qualifications and skills.

Better education will not automatically remove social exclusion. Social exclusion, and education itself, are affected by income inequality, class and/or ethnic divisions in society, physical separation, globalization, the division of power, the stratified nature of the education market, etc. Changes in education and educational aspirations are not enough to compensate for the lack of jobs or the highly competitive modern (global) labour market.

If people are unemployed, it is more likely that they will be poor, although some people who work are also poor due to a low income and large personal and family expenses. Efforts are being made to help people to work and to earn a salary, and thus become in a better position than those who receive assistance and benefits through the unemployment and social welfare system. The main problem is that many people are unemployed and/or are not easily employable and therefore are exposed to economic poverty and social exclusion.

With regard to the wider term social exclusion, it is generally believed that employment and education policies should provide a way out of the problems associated with the unemployment, such as poverty and dependency on social welfare. Many unemployment problems may be alleviated by an active labour market policy. Still, the question remains whether this policy is really successful, or just a way of concealing the problems related to employment.

In order to get satisfying results, an active labour market policy should adjust to changing economic conditions, and focus on the long-term supply of labour, improving factors such as the economic activity rate of the labour force, their level of education, and the flexibility and adaptability of both the employed and those looking for work. It is particularly important that labour market and social welfare policies are coordinated, so that they mutually reinforce one another. The policy which maintains levels of income and benefits during unemployment and the laws protecting employment should also stimulate integration on the labour market and promote its efficiency.

The EU's social inclusion process uses a relative definition of poverty that was first agreed by the European Council in 1975, and is used as definition by Eurostat:<sup>3</sup>

‘...people are said to be living in poverty if their income and resources are so inadequate as to preclude them from having a standard of living considered acceptable in the society in which they live. Because of their poverty they may experience multiple disadvantages through unemployment, low income, poor housing, inadequate health care and barriers to lifelong learning, culture, sport and recreation. They are often excluded and marginalized from participating in activities (economic, social and cultural) that are the norm for other people and their access to fundamental rights may be restricted’.

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<sup>3</sup>[http://ec.europa.eu/employment\\_social/spsi/docs/social\\_inclusion/final\\_joint\\_inclusion\\_report\\_2003\\_en.pdf](http://ec.europa.eu/employment_social/spsi/docs/social_inclusion/final_joint_inclusion_report_2003_en.pdf).

Measuring the poverty requires in advance determined so called „poverty lines” that represents the standard of living level, which should be achieved for one person / household, not to be classified as poor. There are three types of poverty lines: absolute poverty line, relative poverty line and subjective poverty line.<sup>4</sup>

The absolute poverty line represents the determination of the absolute level of incomes (expenditures) which is necessary to satisfy the basic living needs. It is based on the standards about the quantity of goods and services which can be consumed by one person/household, i.e. on the standards for their survival with minimal expenses, while the time and space are used as constant.

The relative poverty line is based on the random setting of the poverty line, according the relative standard for persistence of the household. It can be determined as 50, 60 or 70% from the medial equivalent household consumption.

The subjective poverty line is based on the opinions expressed by the households about what is the minimum acceptable standard of living in the specific country.

The analysis of poverty problem is directly correlated with the determination of precise measures and standards about who will be considered as poor, as well as with the determination of poverty population scope, according those measures. The most usual measures which are used are:<sup>5</sup>

- Head Count Index – which shows the percentage of the population whose incomes are under the established poverty line. It is also known as the term poverty rate. The Head Count Index actually gives answer on the question how much poverty population is there in one country.
- Poverty Gap Index – is measuring the total deficit of all poor persons, i.e. their lack in relation to the poverty line.
- Poverty Severity Index – represents the layout of the poor under the poverty line. The changes in the incomes of the most poor have greater importance, than the changes in the incomes of other groups of poor.

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<sup>4</sup> Eftimoski D., *Economic growth – Basic theoretical concepts and models*, University „Ss. Kliment Ohridski”

- Bitola, Faculty for administration and management of information systems, Bitola, 2009, p.307

<sup>5</sup> *Ibid.*, p.312

The social exclusion is wider aspect than the poverty. If the poverty refers to the lack of material or monetary resources and the poverty policy is directed towards reallocation of the budget funds, the social exclusion, apart from the lack of money and material goods, covers the social, cultural, political and other dimension. The successful realization of the policies against social exclusion, means providing better approach to the institutions and other mechanisms for social integration.

The relation between the social exclusion, poverty and unemployment has multidimensional nature, because it includes numerous material and socio-psychological consequences. This means that the unemployed persons on one hand have reduced revenues, and much poorer social life, and on the other, less chances for integration in the society. The question is how one can maintain social integration, in terms when the labour market can't offer more opportunities for social inclusion of the persons.

## **2. The relation between unemployment, poverty and social exclusion in the Republic of Macedonia**

In accordance with the need for international data comparability, for defining and measuring the poverty in the Republic of Macedonia, the definition of Eurostat is used. The State Statistical Office of the Republic of Macedonia for the calculation of the monetary poverty is using the concept of expenditures (household's consumption) and is calculating the relative poverty line as 70% of the medial equivalent household consumption, using the equivalent OECD scale.<sup>6</sup>

The Republic of Macedonia has very high unemployment rate of 31.4% (2011), as well as very high long-term (over 1 year) unemployment rate of 25.9%. This long-term unemployment is a serious problem, which is reflecting on more than 80% of the total number of unemployed persons. Having in mind this, the result is a large number of people who are longer unemployed and at the same time, are exposed on the danger of economic poverty and social exclusion.

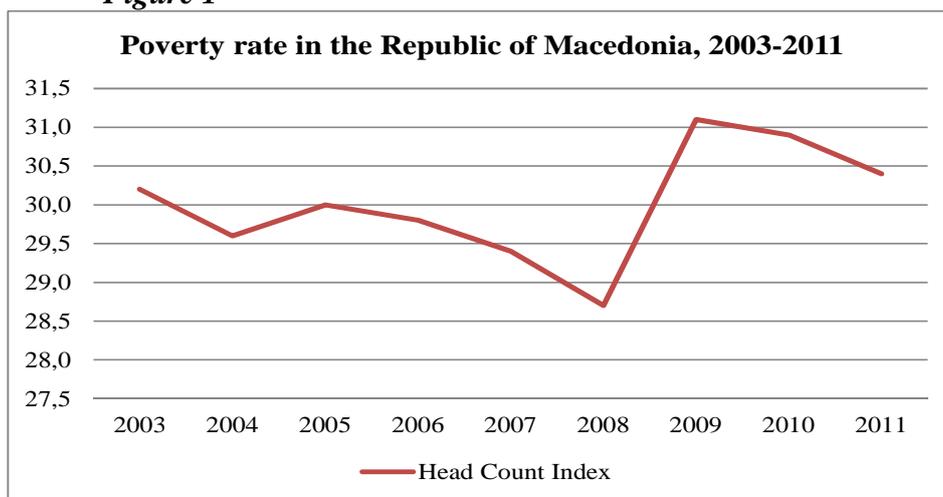
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<sup>6</sup> State Statistical Office of the Republic of Macedonia,  
<http://www.stat.gov.mk/MetodoloskiObjasSoop.aspx?id=37&rbrObl=13>

According to the data in Figure 1, in the period 2003-2011, the poverty rate in the country is around 30%. This means that approximately three out of every ten persons are living under the poverty line, which is determined on 70% of the average annual incomes of the households. The indicator had the highest value of 31.1% (2009), and the lowest of 28.7% (2008). Consequently, having in mind that in the Republic of Macedonia the biggest part of the household expenses are accounted on food (39.3% in 2011), there is a situation which is indicative and typical for the poorer societies.

The poverty in the country usually is related with certain demographic and social characteristics of the population (gender, age, economic activity, education etc.). Therefore there are always some specific groups which are most exposed on the risk to become poor. In the Republic of Macedonia the poorest persons are those economically inactive, unemployed and with the lowest incomes.

**Figure 1**



Source: State Statistical Office, Republic of Macedonia, News release - Poverty line: 4.1.3.94 (2003), 4.1.7.47 (2004-2006), 4.1.8.48 (2007), 4.1.11.48 (2008-2010), 4.1.12.50 (2011)

In this sense, the households whose members are unemployed have the highest poverty rates (Table 1). During the period 2003-2011, the poverty rate of this category of the population had significant increase from 36.1% to 40.7%. These changes are showing that the poverty in the country is deepening, which is confirmed with the poverty gap index of the households whose members are unemployed. The value of this

indicator has increased from 12.1% (2003) to 16.0% (2010), while in 2011 it has decreased to 14.1%.

The reasons for the previously elaborated conditions, i.e. about the highest poverty rate of the unemployed, are due to the limited possibilities for employment in the country (insufficient number of jobs in the economy and weak dynamics on the labour force market, meaning that those who are jobless have difficulties to find employment).

One category of the population who is faced with the highest risk of getting poor is the young people. They have unfavorable social and economic position compared to other age groups, because usually they don't possess property, and have difficulties to find employment or place to live. The two biggest reasons for social exclusion of the young people in Republic of Macedonia derive from their unstable position on the labour market and because they are leaving the education. The unemployment rate of the young (15-24) is around 54% in 2010. These number means that more than half of the labour force of age 15-24 are unemployed.

**Table 1**  
**Relative poverty according the economic status of the household members, 2003-2011**

Year	Poverty rate- Head Count Index	Poverty Gap Index	Structure of the poor
<b>2003</b>			
Unemployed	36,1	12,1	55,4
1 employed	29,3	8,6	30,9
2 and more employed	18,9	5,1	13,7
<b>2004</b>			
Unemployed	39,0	13,8	51,1
1 employed	27,8	8,0	32,6
2 and more employed	18,1	4,9	16,3
<b>2005</b>			
Unemployed	41,5	14,9	52,5
1 employed	28,2	8,3	31,6
2 and more employed	16,8	4,6	15,9
<b>2006</b>			
Unemployed	40,9	14,6	49,5
1 employed	28,1	8,9	31,8
2 and more employed	18,5	5,4	18,7
<b>2007</b>			
Unemployed	39,1	14,1	45,9
1 employed	30,7	9,7	36,0
2 and more employed	17,2	4,8	18,1
<b>2008</b>			
Unemployed	38,4	13,8	43,0
1 employed	30,6	9,1	35,4
2 and more employed	17,9	5,1	21,6
<b>2009</b>			
Unemployed	40,5	13,7	42,7
1 employed	32,5	10,4	33,8
2 and more employed	21,0	6,4	23,5
<b>2010</b>			
Unemployed	41,8	16,0	44,8
1 employed	30,5	10,1	32,8
2 and more employed	20,6	6,6	22,3
<b>2011</b>			
Unemployed	40,7	14,1	46,0
1 employed	30,0	8,4	31,8
2 and more employed	20,2	5,3	22,2

Source: State Statistical Office, Republic of Macedonia, News release - Poverty line: 4.1.3.94 (2003), 4.1.7.47 (2004-2006), 4.1.8.48 (2007), 4.1.11.48 (2008-2010), 4.1.12.50 (2011)

At the same time, the young population who has finished its education, most often accepts flexible types of employment (temporary jobs, part time jobs etc.), which makes them unable to strengthen their social status. In the Republic of Macedonia, usually, young people, especially if they are unemployed, are living with their parents or with other family members. In this situation they are not forced to bear the expenses for live and are not directly exposed to the fury of the poverty and social exclusion.

The risk of poverty and social exclusion is more prominent at the young people who are out of the educational process, who don't have qualifications, who aren't visiting professional trainings and are unemployed. This segment of the labour force commonly is called „status zero youths”.<sup>7</sup>

According the data from the Population Census from 2002, 32.2% of the persons aged 18-24, are prematurely dropping out of education.<sup>8</sup> The participation of these persons according the LFS in 2011 is 13.5% and has significantly decreased since 2007 (19.9%).

In the „Europe 2020: A strategy for smart, sustainable and inclusive growth” is set out that this percentage in our country in 2010 should be 15.5%, while according the general target on EU level, the value of this indicator until 2020 to be under 10%.<sup>9</sup>

Regardless the fact that the data shows significantly reduced participation of the persons who prematurely drop out of school, still their part is big. Dropping out of school is lowering the chances for employment of these persons. As a consequence they may have difficulties to establish their secure position in society, are becoming dependent of the social security system in the country and are facing poverty and social exclusion.

In the Republic of Macedonia, the social transfers (including the pension system and social aid) are having big part in the income structure of the poor, especially of the unemployed. In September 2012, the transfers noted increase of 5.5% compared to the same period in 2011, and they were 62.6% of the total expenditures. The social transfers were 51.798 million MKD denars, were increased for 3.9% and their

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<sup>7</sup> UNDP, *Poverty, Unemployment and Social Exclusion – Croatia*, Denona d.o.o., Zagreb, 2006, p. 22

<sup>8</sup> Pecakovska S. and Lazarevska S., *It's a long way to the society based on knowledge: Macedonian education in the light of the benchmarks and indicators of „Education and training 2010” – Program for work of the European Commission, Foundation Institute Open Society – Macedonia*, Skopje, 2009, p.22

<sup>9</sup> European Commission,

[http://epp.eurostat.ec.europa.eu/portal/page/portal/europe\\_2020\\_indicators/headline\\_indicators](http://epp.eurostat.ec.europa.eu/portal/page/portal/europe_2020_indicators/headline_indicators)

participation in the total expenditures was 45.3%. On the other side, the transfers towards the Pension and disability insurance fund of Macedonia are covering most of the social transfers in amount of 30.582 million MKD denars, they have increased for 5.3% compared to the same period in 2011 and are participating with 26.7% in the total expenditures.<sup>10</sup>

The data explained above shows that in our country there is still big dependence on the social security system. The result is that the state instead of focusing the budget funds for accelerating the economic growth, increasing the investments, opening new jobs and creating better conditions for development, is using them to help the poor, social excluded and unemployed persons.

The analyses of the poverty of the households with employed persons shows that in the period 2003-2011 the poverty rate of the households members with 1 employed person is around 30%, and was increasing until 2009, when the value of the indicator was the highest (32.5%). After that it started to decrease and in 2011 was 30.0%.

In the case of the households with 2 and more employed the situation is almost the same as in the households with 1 employed. The highest poverty rate was in 2009 (21.0%), then it started to decrease and in 2011 was 20.2%.

These numbers shows that even the poverty rate of the households members with one, two or more employed is decreasing, it is still very high. This is due to a low income and large personal and family expenses of some employed persons.

### **3. Strategies and measures for decrease of poverty and social exclusion**

The role of the state in overcoming the problem with the social exclusion, poverty and unemployment is very complex and significant. In that sense, the main strategic goal to decrease the poverty and social exclusion in Republic of Macedonia is „reduction of poverty and social exclusion through better use of the available human and material resources, improvement of the living conditions for all citizens,

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<sup>10</sup> Ministry of Finance, Sector for macroeconomic policy, Newsletter – September 2012, Skopje, November 2012, p. 14

systematic and institutional synergy in function of faster growth, higher standard of living and better quality life”.<sup>11</sup>

In the National strategy on alleviation of poverty and social exclusion in the Republic of Macedonia 2010-2020, is highlighted that it is more appropriate if the policy for social inclusion is represented through measures and possibilities for more universal approach to the social services and benefits, instead of focusing on specific targeted vulnerable groups. With this, the policy for social inclusion would be formed according the needs and possibilities of every citizen who would find himself in position of risk and social exclusion.

During the 2012 were adopted operative plans for 2012 for implementation of the National strategy on alleviation of poverty and social exclusion in Republic of Macedonia 2010-2020. At the same time it is necessary to dedicate special attention to revise the same strategy according the recommendations in Europe 2020.<sup>12</sup>

The most significant priorities, whose realization would improve the conditions of the social exclusion from the labour market in the country are referring to: *first*, locating the reasons for long-term unemployment, and suggesting systematic and other measures to decrease the unemployment; *second*, following the indicators which are detecting the effects of the active labour market policies (or are directed towards the negative action of certain policies) as a precondition to remove the obstacles that are creating the long-term unemployment; *third*, adoption of measures with individual programs and active participation, in order to eliminate the barriers for employment of the long-term unemployed, who are becoming stigmatized and socially excluded; *fourth*, determination the employment quotas for these persons, as well as for the persons with limited abilities, by giving subsidies to the employers who are hiring the socially vulnerable persons, which will provide their bigger social inclusion; and *fifth*, support of the public work initiatives in the regions in which part of the population is exposed to social risks and social exclusion, expecting that this will allow temporary engagements and incomes as well, and will provide better existence and conditions for further hiring of these persons.

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<sup>11</sup> Ministry of Labor and Social Policy, National strategy on alleviation of poverty and social exclusion in the Republic of Macedonia 2010-2020, Skopje, 2010, p.4

<sup>12</sup> In the Programme for realization of the social protection in 2012, in details are explained the areas in which the Ministry of labor and social policy is acting.

Considering the conditions and changes in the field of unemployment, poverty and social exclusion in the Republic of Macedonia, as well as the outlined goals, in the National strategy on alleviation of poverty and social exclusion in Republic of Macedonia 2010-2020, are provided preconditions and measures necessary to overcome the poverty:<sup>13</sup>

- Building a system of permanent measurement through harmonized parameters and data sources, which would be comparable with the indicators that are used to evaluate the poverty line in the European union;
- Determination of the nationally acceptable or adopted definition for social exclusion, according to which analyses can be made, will ease the methodological procedures, but would also specify the policies that will be realized in this area;
- Considering the mechanisms, conditions and assets for timely assistance to the persons who are facing the poverty (urban and rural), defining minimal wage (or minimal income);
- Determination of the targeted groups which should be observed and application of measures and policies for social inclusion through permanent system for solving the problems of socially excluded persons;
- In the socially excluded categories to be included: employed with especially low incomes, rurally poor, women from the ethnic communities who are living in the rural areas, children from larger families (3 and more kids especially with unemployed parents, and children who live in institutions);
- Providing new movable, deinstitutionalized services for more categories of socially excluded groups (different than the existing ones), especially for older persons, as well as increase the number of the daily centers for sheltering the homeless and the children of the streets.

There are several measures and activities provided for support of the socially excluded persons:<sup>14</sup>

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<sup>13</sup> Ministry of Labor and Social Policy, National strategy on alleviation of poverty.....op.cit., p.47

<sup>14</sup> Ibid., p.46

- Improving the conditions in the capacities for inclusion in the educational process and the possibilities to get education (taking over the expenses about the education);
- Relief from certain taxes and contributions (such as participations to use the services from the state or the municipality) in order to decrease the impoverishment of the persons who are facing the social risk, and consequently facing the possibility to become socially excluded;
- Enabling the young to get higher level of contemporary education, which can help them to get away from the zone of the unqualified labour force, that is not attractive for the labour force market;
- Financial help to maintain healthy and hygienic sanitary conditions of the persons and families who are poor, introducing regular free health checks (in order to stop spreading contagious diseases etc.);
- Providing social help which will be in function to the persons who really need it (nonregistered persons, unreported, illiterate, hungry persons etc.) and which also will take in consideration the number of the children in the family that is receiving the social help;
- Providing quality approach to different types of services that are under the influence of the government (health, educational, cultural, sport, fun and other);
- Mapping the social organizations and firms, their capacities, structure and services, in order to evaluate the potential of the institutional and non-institutional forms for social inclusion;
- Setting indicators to follow the energetic poverty and creating measures to decrease or remove the reasons for it;
- Participation of relevant representatives of the ethnical groups and poor people in the preparation and coordination of the social inclusion policies.

Delineating the measures for different groups of poor people is becoming a need, in order to evaluate the success of separate measures. According the National strategy on alleviation of poverty and social exclusion, there are three categories of poor in the Republic of Macedonia. But, since the needs of these categories are different, the measures directed towards them should be different as well. This means:

a) special accent should be given to the trainings and consulting services to those who are considered as newly poor; b) it is necessary to make more available the financial transfers for those determined as traditionally, chronically poor; c) better information for all poor people about the possibilities that are offered.

The relation between the poverty, social exclusion and unemployment is taken in consideration during the preparation of the National Employment Strategy of the Republic of Macedonia 2015. The employment policies and measures outlined in the strategy should stimulate the demand on the labour force market; compliance the supply and demand of labour force according the needs of the labour force market; provide better balance between the flexibility and security, as well as should delineate the grey economy. Reaching these goals will increase the number of employed persons and will decrease the unemployment.

In order to reach the main purpose of the Strategy of 55% employment rate in the country until 2015, there is priority goals defined:<sup>15</sup>

- stimulation of the labor force demand and its harmonization with the supply;
- increase of the employment;
- inclusion of the women, ethnic communities and other vulnerable groups;
- increase the efficiency of the labour market institutions;
- increase of the quality, productivity and security of the employed persons.

Realization of the policies and measures determined in the strategy will increase the employment and will provide better conditions and bigger chances for the poor and socially excluded persons.

## **Conclusion**

The concept of monetary poverty is based on relative measures, which may be responsive to a range of macro-economic policies, for example, relating to redistribution and employment. While poverty may be concentrated within a high proportion of jobless households, there is

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<sup>15</sup> Ministry of Labor and Social Policy, National strategy for employment of the Republic of Macedonia, Skopje, 2011, p. 31

also a risk of poverty among working families, especially where wages are low and family commitments restrict the availability to work. Young adulthood is also considered to be a time of uncertainty and vulnerability, particularly in the current economic climate, which results with significant youth poverty and social exclusion.

Poverty knows no age barrier, nor having in consideration the process of population ageing. With proportionally smaller active population having to support increasing numbers of retired people, it is likely that there will be increasing pressure to provide adequate and sustainable pensions.

Social exclusion is a much broader concept than just income poverty, because there may be many other factors that leave groups of society isolated. These include such wide-ranging factors as unemployment, access to education, childcare and healthcare facilities, living conditions, as well as social participation. The persistence of large numbers of people excluded from work represents a key challenge for the objective of social cohesion. The longer a period of unemployment for an individual, the longer that person generally is staying in social exclusion, through their inability to afford material goods, services and housing, while their social contacts are often reduced (in part due to a lack of money for going out socially, or due to the stigma of being unemployed). This may lead to a lack of confidence and a reinforced sense of isolation.

Having on mind these problems, one can say that the decrease of the poverty and social exclusion in Republic of Macedonia depends on range of factors, among which, except the continuous economic growth, very significant are also the policies for social protection, social inclusion, for education, for health, as well as for the regional development.

The adoption of new solutions in the field of the social policy should be based on the fundamental analysis. This means not only focusing on the economic benefits on short and middle term, but at the same time on the social expenses and influences on long term. In that context, through the policies for active inclusion on the labour market of the poor and socially excluded persons, as well as through increasing the possibility to maintain the social expenditures (pensions, health protection, child protection, long-term care and other social transfers) on appropriate level, the volume of the consumption and the activity of the total population can be maintained.

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