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Do domestic and foreign companies in the country cooperate?

Policy Brief No. 29

The recent analysis found that there is an evident established cooperation between dSMEs and MNCs in the country, though largely determined by (i) the likelihood of MNCs to find the required products and suppliers locally and (ii) the procurement policy of MNCs. It is also found that technological development, standardization and certification, price and production gaps, soft skills and human capital, are the key gaps identified by the three sources of the analysis (stakeholders, dSMEs and MNCs). Accordingly, recommendations for bridging these gaps have been provided, specifically addressed to policy makers, domestic companies and multinational companies in the country.

The objective of this policy brief is to provide recommendations to the policy makers to implement adequate measures and strategies for incentivizing domestic SMEs to increase their competitiveness and therefore enter the supply chain of the multinational companies (MNCs) in the country. Policy makers must improve the overall economic environment and deliver healthy business climate for the enterprises in the country.

This policy brief additionally provides recommendations to domestic SMEs to invest in standardization and technology, as well as in quality and production efficiency. Additionally, MNCs should redefine their procurement policies and engage into mentoring programs with domestic SMEs and support them to invest in innovative production.

Introduction

FDIs are considered a driving force of transition economies: many countries – the Vishegrad and Baltic groups, as well Ireland – followed the "FDI path" of development and achieved significant results. Similarly, FDIs are considered to have positive impact on exports growth and diversification, strengthen industrial base and economic growth, and foster employment. Macedonian governments have been putting efforts to attract Foreign Direct Investment (FDI) of multinational companies (MNC) since 2000, though they significantly intensified in 2007, mainly due to the fast-pace regulatory reforms and new tax policy with reduced and flattered tax rates, launched by the then new right-wing government. Thus, as a result of these reforms, Bbetween 2007 and 2017, the **average FDI inflow** in FYR Macedonia has been about 3.4% of GDP. Still,, although lower than the other countries in the region. FYR Macedonia recorded the **lowest inflow of FDI** (260 million of euros) compared to the other Western Balkan countries. The **manufacturing sector** appeared to be the most attractive sector for foreign investors in the past 8 years (42.3% of the total FDI inflows on average). The main driver of these investments has been the vehicles & other transport equipment industry, with an average share of 74.5% of all total foreign investments in the manufacturing sector. Other significant drivers of FDIs have been the service sector (41.5%) and the construction sector (12.7%).[1]

Apart from the direct impact , such as increased competition on the market, increase of the real per capita GDP and creation of direct jobs, FDIs could provide **indirect benefits** through building linkages between Multinational companies (MNCs) and domestic small and medium enterprises (dSMEs); technology and skills transfer; and improvements in productivity and competitiveness in the overall economy. In FYR Macedonia, these linkages have been quite limited. Moreover, no

[1]Data from DTIDZ

progress is noted in the "FDI and technology transfer" between 2011 and 2017. MNCs in FYR Macedonia are **lightly sourced in the domestic economy**. Less than 10% of their total liabilities have been generated toward domestic companies (FISCAST, 2016), which amounts to negligible 46 million EUR in 2015, which compared to the overall exports of MNCs (cca. 2 billion EUR in 2015) is substantially negligible. The **value chain supply for the SMEs** is even in a worse condition. In general, SMEs participate with only 36% in national export against over 90% contribution to GDP; they mostly export to neighbouring countries, suggesting that their export capacities for countries requiring higher standards are limited.
DSMEs also face low investment in innovation and Research and Development (R&D), and consider the need for new technologies and knowledge capital as minimal or even non-existent. Apart of the gaps in the value chain, soft infrastructure and skill development, there is **lack of transfer-knowledge mechanism from MNCs to dSMEs**, as well information asymmetries. Technical and managerial skills are considered key factors of a country's integration into global supply chains by the IMF study (2016). Moreover, the occasions to bridge information deficit and build network capital between dSMEs and MNCs are rare. FYR Macedonia recorded the lowest inflow of FDI (260 million of euros) compared to the other Western Balkan countries. The manufacturing sector appeared to be the most attractive sector for foreign investors in the past 8 years (42.3% of the total FDI inflows on average). The main driver of these investments has been the vehicles & other transport equipment industry, with an average share of 74.5% of all total foreign investments in the manufacturing sector. Other significant drivers of FDIs have been the service sector (41.5%) and the construction sector (12.7%).

Approach

This study is based on mixed method approach, including: (1) **semi-structured interviews** - the first round is conducted with stakeholder organizations (Economic Chambers, International organizations, Business confederation, policymakers, DTIDZ, relevant policymakers), followed by a round of interviews with representatives of MNCs operating in the country; (2) **focus group with domestic SMEs** and (3) **online surveys** - two surveys are conducted, one for MNCs in the country and another for dSMEs, including a general part with basic company information questions (location, sector, number of employees, type of investment, etc.) and part with specific questions about the gaps and the potentials for cooperation.

Results

There is an evident established cooperation between dSMEs and MNCs in the country. **81.5% of MNCs** in the country answered they **cooperate or have cooperated with dSMEs**, compared to **18.5%** that **have not established any kind of cooperation**. The **benefits of cooperation with domestic suppliers** identified by MNCs include: fast delivery due to proximity with suppliers, lower

transportation and logistics costs, better communication due to the direct contact with the suppliers, easy and fast procedures etc. On the other hand, dSMEs benefit from the cooperation by expanding their production and business operations, and by becoming technologically advanced and certified producers.
The analysis identified some factors for successful cooperation, such as: **good product quality**, **competitive price** and **on-time delivery**. Additionally, business confidence and good communication among the parties is essential. On the other hand, **dSMEs require greater openness of the MNCs, less strict requirements and on-time payment with shorter payment period.**
The possibility for cooperation and satisfying the need for procurements in certain sectors/products is largely determined by **the likelihood for the foreign companies to find the products and a supplier** for the requested products locally.
At the same time, **the access to information for domestic suppliers is very difficult**. A unique repository database is missing about the potential domestic suppliers, and there is a lack of a single database of information for all foreign investors in the country. **Procurement policy of MNCs in the country has been found an important determinant of the cooperation with dSMEs.** There are differences in the procurement decision making policy at the local and mixed levels, depending of the type of purchases (raw materials

or services). In general, services procurement decisions are made mainly at the local level, compared to raw materials procurement decisions that are made at the centralized or mixed level. Taking into consideration the type of investment and the location of investments, greater potentials for cooperation exist between dSMEs and MNCs operating outside the technological industrial zones, rather than between dSMEs and MNCs in the zones

The analysis identified several gaps in the cooperation between MNCs and dSMEs in the country. **Insufficient technological development and readiness of dSMEs, the standardization and certificates implementation** and **the production capacity** have been considered as the main three (out of eleven) weaknesses by MNCs, having the highest rate of importance on cooperation. **Insufficient technological development and readiness of dSMEs** has been ranked as the main weakness by MNCs, having the highest rate of importance on cooperation. According to the domestic companies, they are not ready to invest in new technologies, since they face high financial risks in terms of illiquidity and cannot achieve sustainability in their sales. **The standardization and certificate implementation gap** exists due to not implemented or not fully implemented quality and safety standards and internationally

accepted certificates, especially in the automotive industry. There is misperception in the viewpoint of MNCs and dSMEs regarding the level and adequacy of standardization, relevant for the cooperation. Even though MNCs argue that domestic producers are lacking technological standards, 75% of the domestic companies have responded they have implemented technological standards in their operations. However, the majority of dSMEs are holding some of the ISO, safety and health security standards, but only a limited number of dSMEs have implemented specific standards required by the MNCs. Additionally, the standardization and certification processes are considered as expensive processes among dSMEs and therefore not many of them can afford to implement more than one standard or certificate. According to the MNCs, **the limited capacity of production of dSMEs** is one of the main issues when cooperation needs to be established. From the stakeholders' point of view, the gap in the production capacity exists due to the lack of attentiveness of the domestic companies to invest in growth and development of their production plants. The unsustainable and affordable sources of financing is considered as the main reason for poor investments in production capacity according to the dSMEs. **The uncompetitive price of dSMEs products, the organizational gap and the human capital and soft skills are additional gaps** identified in the cooperation. As part of the organizational gap, **poor responsibility** on the part of dSMEs towards meeting the terms of their contracts and pursuing on-time delivery have been identified as bottlenecks. While, the **lack of soft skills** is mostly concerning the networking and the ways in which dSMEs have approached MNCs.

Recommendations to policymakers

Measures for standardization process improvement: (1) The government to provide subsidies for improvement in standardization

and certification of the domestic service providers (fully paid upon implementation), for the most specific standards required by the MNCs, such as: ISO:50001, IATF 16949, TS16949, etc.; (2) The government to provide subsidies to domestic businesses, by covering 50% of the cost for implementing standards and certificates and by covering 100% of the costs associated with trainings of the staff that implement the standards and certificates within the companies; (3) Grants for any implemented standard that will increase cooperation with MNCs. Repayment based on success of obtaining new customers in a period of three years after certification; i.e. if receiving 5 new international customers, no need to pay the money back; If 3 customers – 50% repayment; 1 customer – 75% repayment; 0 customers – full repayment.

Measures to stimulate raw material and inputs production. Package of measures for domestic companies, composed of: tax incentives, state land and re-payment grants without interest rate for new investment and increased production of raw materials and inputs.

Incentivizing new FDIs with a higher value added and promoting upgrades among the investors already present (improvement of Measure 9 in the ERP). The method can enhance the efficiency and effectiveness of the activity within the measure that plans support of major impactful economic projects in the country by supporting involvement of domestic companies in international value chains.

The strategy for attracting foreign investments **to avoid targeting large scale companies**, in need of a large number of employees and low paid jobs due to the lack of adequate work force. Instead, the strategy should be targeting: (1) Companies with higher value-added products and services, which in turn require more skilled labor and consequently higher paid jobs; (2) Brownfield investments; (3) Medium sized companies with up to 150 employers;

Strategy for incentivizing M&A activities among domestic companies, in order to strengthen the domestic enterprises. Such strategy will contribute in the creation of companies with higher capacity and expertise that are able to satisfy the demand of MNCs. M&A activities will additionally lead to decreased number of small-sized enterprises and rather increased number of medium-sized enterprises that are better positioned and more competitive on the market. This devised strategy can complement the activities listed in Measure 9 from the ERP.

Easy, fast and quality access to information for foreign investors and potential domestic suppliers in the country, to facilitate the establishment of cooperation.

The government to build unique repository database about the potential domestic suppliers classified by sector, type of products, production potential, etc. and foreign investors in the country, classified by type of investments, sector, products and location. The government and the state agency for foreign investments and export promotion to establish system of SME support and to promote domestic suppliers by organizing supplier's days and reverse exhibitions.

Further reduction of customs tariffs and facilitation of the customs procedure for import of raw materials and inputs.

Recommendations to domestic companies

The following proposed measures should incentives domestic companies to focus in research, access to finance and improvement in skills that will enhance growth and capacity building. Service providers **to invest in standardization process**, with a focus on standards and certificates required by the foreign investors in the country.

Producers of raw materials and inputs **to invest in quantity of production, price competitiveness, quality and production efficiency.**

To increase corporate culture, mindset and mentality in cooperation with foreign investors in terms of: (1) providing precise delivery deadlines and pursuing on-time delivery; (2) improving responsibility towards meeting the terms of their contracts; (3) Being more aware and informed about global market and corporate culture of foreign companies in the country.

To improve the soft skills in terms of: (1) representing their business on higher professional level at global and international fairs; (2) increasing the networking with MNCs; (3) Improving the approaching strategy by preparing adequate presentation of their company and products/services and representative materials (brochures, business cards, catalogues of products, etc.).

Recommendations to multinational companies in the country

To redefine procurement policies, especially companies that operate in the technological industrial zones. The procurement decision making policy to be shifted from the centralized to local level to the extent possible.

MNCs **to invest in mentoring programs**, and capacity building of domestic suppliers. The investment could be in joint activities for smooth transition and adaptation of domestic suppliers to the standards required by the MNCs, leading in the standardization and implementation process.

To motivate domestic producers to invest in new production with guaranteed further supply to the foreign companies or long-term contracts.

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