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DOES DEMOCRACY AND GOVERNMENT POLICY AFFECT LABOR MARKET OUTCOMES IN CEE COUNTRIES?

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DOES DEMOCRACY AND GOVERNMENT POLICY AFFECT LABOR MARKET OUTCOMES IN CEE COUNTRIES?

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ABSTRACT

In this paper, in a sample of Central and Eastern European countries (Albania, Bulgaria, Czech Republic, Estonia, Hungary, Macedonia, Moldova, Romania, Russian Federation, Slovak Republic, Slovenia, and Ukraine) we investigate the effects of: 1) democracy (measured by democracy indices); 2) government related variables and 3) other selected macroeconomic variables, on labor market outcomes. As labor market outcomes we use the following variables: unemployment rate, long-term unemployment rate, employment to population ratio, and average annual hours worked. As independent government related variables we use the following ones: government consumption (lagged), tax revenues as percentage of GDP (lagged), Herfindahl index of government (lagged). For the level of democracy we use following indices: Freedom house political rights and Civil liberties index (lagged), worker rights by CIRI human rights data project and Physical integrity rights index (lagged). Finally (regarding the independent macroeconomic variables), we estimate the effects of economic growth, inflation, and gross capital formation, on labor market outcomes. The empirical findings are based on two econometric techniques: The Seemingly Unrelated Regressions (SUR), and the General Method of Moments (GMM).

KEYWORDS: Labor market institutions and outcomes, Democracy, Central and Eastern European countries.

JEL CLASSIFICATION: J08, J01, H51, H55, H83

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1. INTRODUCTION AND LITERATURE REVIEW

There is no doubt that the labor market efficiency depends both on the economic policy, as well as on the level of democracy practicing in certain society. The democracy can be defined as a model of political organization, where political power is more equally distributed. Though democracy has very attractive features, this model of political organization may lead to inefficient policies and high levels of income redistribution.⁴

Democracy and democratic labor market institutions and their influence on labor market outcomes had been subject of debate of the economists for the past two decades.⁵ As Barro⁶ noted, more democracy encourages rich to poor redistributions and may enhance the power of interest groups. In another paper, Barro⁷ once again concludes that the net effect of democracy on economic growth is inconclusive, which is supported by similar conclusion in the Gerring et al., paper.⁸

Labor economists and economists in general, by democracy on labor market usually mean political rights and civil liberties. Polity IV project by Marshal and Jeggors⁹ data base is a reliable source for explaining democracy on labor market and worker rights. These set of rights, are mostly defined in labor and employment laws that express and constitute type of social contract.¹⁰ The social contracts define the obligations between workers and employees, and also represent some kind of

⁴ Acemoglu, D. (2008), "Oligarchic Versus Democratic Societies." *Journal of the European Economic Association*, Vol. 6, Issue 1, pp. 1-44.

⁵ Lehmann, H., Muravyev, A. (2009), " How Important are Labour Market Institutions for Labour Market Performance in Transition Countries?" IZA DP No. 4673.

⁶ Barro, R. (1999), "Determinants of Democracy." *Journal of Political Economy*, 107(S6), pp. 158-183.

⁷ Barro, R. (1996), "Determinants of Economic Growth: A Cross-Country Empirical Study." NBER Working Paper, No.5698.

⁸ Gerring, J., Bond, P., Barndt, W., Moreno, C. (2005), "Democracy and Growth: A Historical Perspective." *World Politics*, 57 (3), pp. 323-64.

⁹ Marshal, M., Jeggors, K. (2002), *Polity IV Project, Integrated Network for Societal Conflict Research (INSCR) Program Center for International Development and Conflict Management (CIDCM)*. University of Maryland, College Park 20742.

¹⁰ Rittich, K. (2010), "Between Workers' Rights and Flexibility: Labor Law in an Uncertain World." *Saint Louis University Law Journal*, Vol. 54, p. 565.

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mechanisms aimed for shearing the benefits and costs emanating from the economic activity.

In the period from 1960's till the 1990's, many European countries have enacted various job security provisions¹¹, and in many of them the employer's ability to terminate job contract at will is restricted. Lazear in his paper from 1990 finds evidence that increase in severance pay lowers the number of jobs in the economy. Also, as Blanchard and Wolfers¹² note, about the institutions and labor markets, unemployment insurance has led to chronic unemployment. They state that the costs associated with the employment protection have "killed" the job creation.

In some studies, such as that of Nickel¹³, labor market dynamics is being attributed to the changes in institutions only (this conclusion is being drawn from the OECD countries). Bertola, Blau and Kahn¹⁴, on the other hand, explained that macroeconomic and demographic shocks and changing labor market institutions have little to explain about the US unemployment, but much more to explain about the US relative unemployment. Some studies, as Blanchard and Gali¹⁵, connected unemployment, productivity shocks and the monetary policy. Their model proved that, under standard utility specification, productivity shocks do not affect unemployment.¹⁶

Recently, labor economists introduce the idea that individual policies interact systematically with the overall institutional framework. Recently, also, some studies have focused on the degree of competition on the product market and financial market development. In that context, the paper by Amable, Demmou and Gatti¹⁷, provide

¹¹ Lazear, E. P. (1990), "Job Security Provisions and Employment." *The Quarterly Journal of Economics*, Vol. 105, no. 3, pp. 699-726.

¹² Blanchard, O., Wolfers, J. (2000), "The Role of Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence." *Economic Journal*, 110(462), pp. C1-33.

¹³ Nickel, S. (1997), "Unemployment and Labor Market Rigidities: Europe versus North America." *Journal of Economic Perspectives*, Vol. 11, No. 3, pp. 55-74.

¹⁴ Bertola, G., Blau, F., Kahn, L. (2001), "Comparative Analysis of Labour-Market Outcomes: Lessons for the United States from International Long-Run Evidence." NBER Working Paper No. 8526.

¹⁵ Blanchard, O., Gali, J. (2007), "Labour Markets and Monetary Policy: A New-Keynesian Model with Unemployment." NBER Working Paper No. 13897.

¹⁶ It is through real wage setting and the labor market frictions, one way by which productivity shocks effects on unemployment, are determined.

¹⁷ Amable B., L. Demmou and D. Gatti [2007] Employment Performance and Institutions: New Answers to an Old Question. IZA DP No. 2731. Discussion Paper Series, Bonn: IZA.

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evidence on the linkages between large array of institutional arrangements on product, labor and financial markets.

Developing countries are interesting for investigation of the employment laws and regulatory reforms connected with the labor market.¹⁸ On the topic of regulation of labor market, Besley and Burgess¹⁹ suggested that regulating in a pro-worker direction is associated with the increases in urban poverty. In the investigation of 85 countries worldwide, Botero et al.,²⁰ found that richer countries regulate labor less than poor countries, although they have more generous security systems.²¹ In general, heavier labor regulation, according to the previous paper, is associated with larger unofficial economy and higher youth unemployment.

From the government related variables, the one that is most directly related as a proxy of government is Herfindahl index of government concentration²². Larger the number of parties in the coalition, lower the index. If it is one-party system this index would take value one, otherwise it would take value between 0 and 1.²³ In his study, Wohlschlegel²⁴ investigated the effect of corruption on unemployment. He concludes that voters in corrupt countries elect single strong party, because they expect single party government to be more successful in coping with such a corrupted environment. So, in a way, government concentration and corruption are positively associated. But, also, corruption increase unemployment, though this effect is weaker in countries with

¹⁸ Djankov, S., Ramalho, R. (2009), "Employment Laws in Developing Countries." *Journal of Comparative Economics*, 37(1), pp. 3-13.

¹⁹ Besley, T., Burgess, R. (2004), "Can Labor Regulation Hinder Economic Performance? Evidence from India." *Quarterly Journal of Economics*, 119 (1), pp. 91-134.

²⁰ Botero, J., Djankov, S., La Porta, R., Lopez-de-Silanes, L., Shleifer, A. (2004), "The Regulation of Labour." *Quarterly Journal of Economics*, 119 (3), pp. 1339-1382.

²¹ Left-wing governments are associated with more stringent labor regulations, and more generous security systems.

²² This index is calculated as: $H = \frac{\sum_{i=1}^n s_i^2}{n}$ where s_i represents the number of the seats in parliament held by each party supporter of the government with respect to total seats in parliament. This index ranges 0 to 1.

²³ Longoni, E., Gregorini, F. (2009), *Inequality, Political Systems and Public Spending*. University of Milan – Bicocca.

²⁴ Wohlschlegel, A. (2012), "Government Concentration: Cause of or Remedy for Corruption?" (November 30, 2012). Available at SSRN: <http://ssrn.com/abstract=2183120> or <http://dx.doi.org/10.2139/ssrn.2183120>.

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more concentrated governments. Thus, the effect of government concentration on unemployment is ambiguous.

Government size is usually measured by the government consumption, as percentage to GDP. Many research studies estimate the effect of government size on labor market outcomes, such as unemployment. For example, Feldmann's²⁵ study uses data from 1985 to 2002 for 19 industrialized countries and his main finding is that the large government sector is likely to increase unemployment. Karras²⁶ in his study observed negative employment effects of government spending in eight countries, on a sample of 18 countries.

Table 1. Summarized Literature Review

Study	Used measures	Econometric technique	Main findings
Acemoglu (2008)	Protection of property rights.	None, theoretical model and historical perspective.	Oligarchic society may first become richer, but then fall behind similar democratic society.
Amable, Demmou and Gatti (2007)	Unemployment rate, inactivity rate, jobless rate.	OLS, Fixed effect vector decomposition estimator, GLS, and panel corrected standard error estimator.	Positive effect of employment protection on employment performance.
Barro (1999)	Democracy measured by a subjective indicator of electoral rights, political rights index and civil liberties index, gaps between female and male in years of education, urbanization rate, etc.	Panel study of over 100 countries from 1960-1995.	Democracy has little with the country size (measured by the log of population) but it has significant association with the income. Democracy rises with the middle class share of income. For a given standard of living, democracy fall with the urbanization.
Blanchard and Gali (2007)	Unemployment rate with the productivity shocks and introduction of real wage rigidities.	None, theoretical new-Keynesian model.	Under standard utility specification, productivity shocks have no effect on unemployment, but once real wage rigidities are introduced inefficient unemployment arises.

²⁵ Feldmann, H. (2006), *Government Size and Unemployment: Evidence from Industrial Countries*. University of Bath.

²⁶ Karras, G. (1993), "Employment and Output Effects of Government Spending: Is Government Size Important?" *Economic Inquiry*, Vol. 31, no. 3, pp. 354-369.

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Blanchard and Wolfers (2000)	European unemployment interaction with the labor market institutions, as presented by: employment protection tax wedge, union density bargaining power, etc.	Panel study for 20 OECD nations. Data cover period since 1960.	Relationship between shocks and institutions are crucial in explaining unemployment.
Djankov and Ramalho (2009)	Labor regulation and labor market outcomes, also the interaction between labor market rigidities and labor market outcomes.	Survey of the research of the effect of the employment laws in developing countries (using papers published since 2004).	Developing countries with rigid employment laws tend to have larger informal sectors and higher unemployment, especially among young workers.
Feldmann (2006)	Government consumption and taxes, and their effect on unemployment rate. As government size related variables are taken: state owned enterprises, and transfers and subsidies.	Generalized least squares estimate. This study uses data of 19 industrialized countries.	Large government sector is likely to increase unemployment.
Gerring et al., (2005)	Dependent variable in this study is economic growth and main emphasis has been out on the relationship between economic growth and the level of democracy. Democracy is being measured by the Polity IV score.	Cross-country regression.	Relationship between democracy (democracy level and stock) and economic growth is thus robust and positive.
Lehmann and Muravyev (2009)	Labor market outcomes unemployment rate, long term unemployment rate and employment protection legislation along with the active labor market policies.	Panel study with lagged regressors, in order endogeneity problem to be solved.	Institutions matter for labor market outcomes, and that deregulation of market improves their performances.
Nickell (1997)	Unemployment rate, interaction with labor market institutions: employment protection, active labor market policies, union density, union coverage index.	Panel random effect GLS for 20 OECD countries, for the period 1983-88 and 1989-1994.	European labor market is rigid and inflexible, so the result is high unemployment. North American labor market is dynamic and flexible, so the result is low unemployment.
Wohlschlegel (2012)	Corruption and government concentration with relation to unemployment rate.	Causality analysis.	Corruption increases unemployment. This effect is weaker in countries with more concentrated governments.

2. DATA

We use annual data for 12 countries from CEE group (Albania, Bulgaria, Czech Republic, Estonia, Hungary, Macedonia, Moldova, Romania, Russian Federation, Slovak Republic, Slovenia, and Ukraine) for the period 1993 - 2011. Data on labor market

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outcomes: unemployment rate, long-term unemployment rate (unemployed for more than 12 months), average annual hours worked and employment to population ratio, are available from Penn World Tables. Also, from this table are gathered data on capital formation (physical capital). Data on government consumption, inflation and, taxes as percentage of GDP, are obtained from the World Bank. Data on Freedom House political rights and Freedom house civil liberties are obtained from the Pippa Noris shared data sets, from John F.Kennedy School of government at Harvard University. Herfindahl index of government concentration has been derived from data base on political institutions. Data on worker rights and Physical integrity rights index are provided from CIRI human rights data project by Cingranelli and Richards²⁷. The descriptive statistics of the variables used in estimations is presented in Table 2:

Table 2. Descriptive statistics and variables description

	Variable	Mean	Std. Dev.	Min	Max	Observations
Emplp	Employment to population ratio	50.31903	6.359795	32.4	62.7	N = 247
Avh	Average hours worked	1857.352	151.7761	1593.38	2293.48	N = 228
Ltur	Long term unemployment	5.41407	4.945736	0.9	30.2	N = 199
Unem.rate	Unemployment rate	11.20787	7.231255	3.9	37.3	N = 216
Worker	Workers' rights (CIRI)	0.866397	0.812982	0	2	N = 247
Herfgov	Herfindahl index of government concentration	0.466005	0.376019	0	1	N = 247
Physint	Physical integrity rights index	3.678862	2.990891	0	8	N = 246
logRGDP	Logarithm of real GDP	9.049146	0.676928	7.290968	10.20836	N = 234
Inflation	Inflation (CPI)	48.07333	17.80478	6.74	91.2	N = 234
Gov.cons	Government consumption	9.093803	2.46359	4.81	19.28	N = 234
Tax revenues as percentage of GDP	Taxes (% of GDP)	16.84172	4.332618	5.96	26.87	N = 180
Gross capital formation	Gross capital formation (wealth)	2.28E+10	5.54E+10	1.62E+08	4.64E+11	N = 247

²⁷ Cingranelli, D., Richards, D. (2010), "The Cingranelli and Richards (CIRI) Human Rights Data Project." *Human Rights Quarterly*, 32 (2010), pp. 395–418.

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FH_PR	Freedom House political rights index	3.919028	2.553796	1	7	N = 247
FH_CL	Freedom House civil liberties index	2.894737	1.606976	1	7	N = 247

3. METHODOLOGY OF THE APPLIED ECONOMETRICS WORK

Zellner²⁸ proposed efficient method of estimation which is generalization of the linear regression model. Namely, Zellner proposed estimation technique that yields more efficient coefficient estimator than single equation least squares estimators, such as OLS. In this way coefficients are estimated simultaneously by applying generalized least squares to the whole system. In the algebraic form let first:

$$y_i = X_i\beta_i + u_i \tag{1}$$

In matrix form previous expression can be written as:

$$\begin{bmatrix} y_1 \\ y_2 \\ \vdots \\ y_I \end{bmatrix} = \begin{bmatrix} X_1 & 0 & 0 \\ 0 & X_2 & 0 \\ \vdots & \cdot & \vdots \\ 0 & 0 & X_I \end{bmatrix} \begin{bmatrix} \beta_1 \\ \beta_2 \\ \vdots \\ \beta_I \end{bmatrix} + \begin{bmatrix} \varepsilon_1 \\ \varepsilon_2 \\ \vdots \\ \varepsilon_I \end{bmatrix} = X\beta + \varepsilon \tag{2}$$

In Zellner’s SUR models $I > 1$, i.e. number of dependent variables is greater than one, number of dependent variables that allow for different regressor matrices in each equation may differ i.e. $X_i \neq X_j$. This method of estimation, also, accounts for contemporaneous correlation i.e. $E(\varepsilon_{it}, \varepsilon_{jt}) \neq 0$.²⁹ The vector of all stacked independent variables is: $Y = (y_1', y_2', \dots, y_I')$, X is the block diagonal matrix, $\beta = (\beta_1', \beta_2', \dots, \beta_I')$ is the vector of stacked coefficient of all equations. Then, the OLS estimation of the system would be $\beta^{OLS} = (X'X)^{-1}X'y$. The SUR model accounts for interrelations between equations, assuming that error terms from the different equations are correlated, i.e. $\beta^{SUR} = [X'\Omega^{-1}X][X'\Omega^{-1}Y]$, where Ω^{-1} is a weighting

²⁸ Zellner, A. (1962), "An Efficient Method of Estimating Seemingly Unrelated Regression Equations and Tests for Aggregation Bias." *Journal of the American Statistical Association*, No. 57, pp. 348–368.

²⁹ Hubert, M., Verdonck, T., Yorulmazb, O. (2014), "Fast Robust SUR With Applications to the Multivariate Chain Ladder Method." *preprint send to Elsevier*.

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matrix based on a covariance matrix of the error terms. This covariance matrix is the expected value of the error terms of the n^{th} observation in the i^{th} equation. The covariance is $\sigma_{ij} = E(\varepsilon_{in}, \varepsilon_{jn})$. The elements of the covariance matrix can be calculated

as: $\hat{\sigma}_{ij} = \frac{\hat{\varepsilon}_i \cdot \hat{\varepsilon}_j}{N}$. Now, we know that $\Omega = \sum \otimes I_N$, where \otimes is the Kronecker product actually block matrix³⁰. In the second step generalized least squares regression is being run for the β^{SUR} , so estimation is:

$$\beta^{SUR} = [X' (\hat{\Sigma}^{-1} \otimes I_N) X]^{-1} [X' (\hat{\Sigma}^{-1} \otimes I_N) y] \quad (3)$$

In a large sample, such as in this paper, this estimator is asymptotically efficient. The assumption of independence of the labor market outcomes is not really supported by the economic theory. That is why one can think that single equation OLS approach would be inefficient from a statistical point of view.³¹ Since some of the regressors appear to be endogenous, we use seemingly unrelated regressions with lagged regressors - to solve the endogeneity problem. Seemingly unrelated regressions technique implies that, in general equilibrium analysis, all variables are endogenous and only estimation that could be done is with exogenous/lagged values of endogenous variables i.e. reduced form of the equations.³²

GMM dynamic panel data model, i.e. Arellano-Bond estimation³³, has also been applied in order to account for the endogeneity problem. The first-order liner dynamic panel model can be expressed by the following regression:

$$y_{it} = \beta y_{i,t-1} + \gamma x_{i,t} + (\alpha_i + \varepsilon_{i,t}) \quad (4)$$

³⁰ If matrix A is $m \times n$, and matrix B is $p \times q$ matrix, then *Kronecker product* is:

$$A \otimes B = \begin{bmatrix} a_{11}B & \dots & a_{1n}B \\ \vdots & \ddots & \vdots \\ a_{m1}B & \dots & a_{nm}B \end{bmatrix}$$

³¹ Judge, G. G., Hill, R. C., Griffiths, W. E., Lutkepohl, H., Lee, T. C. (1988), *Introduction to Theory and Practice of Econometrics*. 2ed, Wiley New York

³² Kennedy, P. (2003), *A guide to Econometrics*. MIT press, fifth edition.

³³ Arellano, M., Bond, S. (1991), "Some Tests of Specification for Panel Data: Monte Carlo Evidence and an Application to Employment Equations." *Review of Economic Studies*, 58, pp. 277-297.

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where: $i(=1, \dots, N)$ is standing for a cross-section group, while $t(=1, \dots, T)$ for time period. The expression in parenthesis is composite error term that "covers" group-specific random effect (α_i) (that is time invariant) and the error term ($\varepsilon_{i,t}$) that is assumed to be $IID(0, \sigma_\varepsilon^2)$, and that varies over both groups and time. In order to solve the time invariant problem of the group-specific random effect (α_i) - which biases estimation of (β) - the equation (4) is transformed into the following expression:

$$y_{i,t} - y_{i,t-1} = \beta(y_{i,t-1} - y_{i,t-2}) + \gamma(x_{i,t} - x_{i,t-1}) + (\varepsilon_{i,t} - \varepsilon_{i,t-1}) \quad (5)$$

Due to the correlation problem between the lagged $y_{i,t}$ and $\varepsilon_{i,t}$, as well as the correlation problem inside the error term structure, the instrumental variables are applied. More precisely, for example, the lagged difference ($y_{i,t-1} - y_{i,t-2}$) is substituted with ($y_{i,t-2} - y_{i,t-3}$)³⁴, or with the lagged level ($y_{i,t-2}$).³⁵ The instrument should be highly correlated with ($y_{i,t-1} - y_{i,t-2}$), but not correlated with ($\varepsilon_{i,t} - \varepsilon_{i,t-1}$). Moreover, if ($x_{i,t}$) are strictly exogenous, then $E\{x_{i,s} \Delta \varepsilon_{i,t}\} = 0$ for each s and t , so that $x_{i,1}, \dots, x_{i,T}$ can be used as an instruments in eq.5. The Arellano – Bond estimation uses lagged levels as instruments.

4. RESULTS

In this empirical section, we apply seemingly unrelated regressions technique (SUR), for panel data. Basically, one can use SUR when dealing with longitudinal panel data. This technique is being usually applied if there exist unequal variances in the data, and more important - if the error terms amongst the equations are correlated.

³⁴ Greene, W. (2002), *Limdep Version 8.0: Econometric Modeling Guide*. Vol.2, Plainview NY: Econometric Software, Inc.

³⁵ Arellano, M. (1989), "A Note on the Anderson-Hsiao Estimator for Panel Data." *Economics Letters*, 31, pp. 337-41.

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The SUR consists of equations explaining identical variables, but for different samples. Using SUR, when the equations are related only with their error terms, we achieve higher estimation efficiency. In fact, the SUR estimator is efficient under the assumptions we have made, because it is just a special case of the GLS estimator (if the error terms are uncorrelated across equations, the GLS and OLS estimators are numerically identical). We assume that the equations in our models are independent, but that correlation among the error terms of the equations exists, representing identical unsystematic influences. Furthermore, we use lagged regressors to account for the potential endogeneity. Finally, the GMM model, i.e. Arellano-Bond estimation, is being applied to account for endogeneity, but also to account for short and long run effects.

In the first model, as democracy indicator, Freedom house political rights measure has being used. The other variables include workers' rights ($Worker_{it}$), Herfindahl index of government ($Herfgov_{it}$), Physical integrity rights index ($Physint_{it}$) and inflation ($Inflation_{it}$). Variable related with the economic activity is the logarithm of real GDP ($logRGDP_{it}$), while the gross capital formation – as a proxy for wealth, and the tax revenues - as percentage of GDP (T_{it}), are included too. In the model 2, the only regressor that is different is the Freedom house civil liberties measure. In fact, we have introduced this measure instead of Freedom house political rights index in order to test the robustness of the impact of democracy on labor market outcomes, when the democracy measure is changed. In the model 3 government consumption, as a proxy for macroeconomic policy, has been introduced among the regressors. This model, also, includes Freedom house political rights index - as measure for democracy, and the other standard regressors from model 1 and model 2. Model 4 is GMM model, and it is Arellano-Bond estimation, where among the regressors are included: worker's rights measure, Herfindahl index of government concentration, Physical integrity rights index, Freedom house civil liberties index and government consumption, and other standard regressors from the first three models. The results from the different models are presented in the appendix (Tables 3, 4, 5 and 6).

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In the model 1, Freedom house political rights index, as measure of democracy, is positively associated with employment to population ratio, but negatively associated with the long-term unemployment rate and general unemployment rate. These results are *a priori* expected, since it is acceptable that higher level of democracy increases employment and the number of annual hours worked, and thus reduce the long-term unemployment and unemployment in general. Logarithm of real GDP is positively associated with the employment to population ratio and also positively associated with the long-term unemployment rate and general unemployment rate (with rise of productivity, fewer workers will be needed to produce the same amount of output). So, in the short run, incremental increase in productivity, causes rise of unemployment, but in the long run unemployment effect disappears.³⁶

In the model 2, one can see that democracy index is significant only in the first equation. Otherwise, freedom house civil liberties do not enter significantly in either equation. Worker rights do significantly influence average annual hours worked and employment to population ratio, while they enter negatively when in association with long-term unemployment and unemployment rate.

In the model 3, workers rights have significant positive effect on the average annual hours worked, and they enter negatively and significantly with the unemployment rate. Government consumption seems to have negative effect on employment to population ratio and on average annual hours worked, while the effect is positive on long-term unemployment and unemployment rate. Hence, fiscal prudence is needed in these countries. Tax revenues, as expected, affect negatively on average annual hours worked and employment to population ratio. Democracy affects employment positively and significantly, and has negative impact on unemployment related variables.

Finally, with the model 4 the short and the long-term effects on labor market variables are captured. The results suggest that the Freedom house civil liberties, on a short run, decrease employment to population ratio, but on a long run increases long-

³⁶ Blanchard, O., Solow, R., Wilson, B.A. (2007), *Productivity and Unemployment*. MIT Economics.

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term unemployment, in the dynamical framework. Physical integrity rights index reduces long-term unemployment rate on a long run.

5. CONCLUSION

Regression results prove that increase in the worker rights index will induce on average higher employment to population ratio, and will increase annual hours worked. Also higher lagged worker rights will reduce long-term unemployment and general unemployment rate. Democracy indices, on average, increase employment to population ratio and average annual hours worked, and reduce long-term unemployment rate and general unemployment rate. However, these results are conditional upon the analysis on a short and on a long run, i.e. the Arellano-Bond estimation. When analyzed in terms of time effect, on a long run, Freedom house civil liberties index reduces employment to population ratio and increases long-term unemployment rate, while, on a short run, this index significantly increases the general unemployment rate.

Herfindahl index of government concentration, on average, it does significantly increase long-term unemployment rate and general unemployment rate. On a long run, this index increases long-term and general unemployment rate. It satisfies our expectations that smaller democracy levels (higher government concentration, which means higher Herfindahl indices) result in higher unemployment rates. The same can be concluded for the Physical integrity rights index. On average, it does positively and significantly affect the long-term unemployment rate and general unemployment rate. On a long run, higher Physical integrity rights index, on average, reduces long term unemployment rate, whereas on a short run, it generally reduces the unemployment rate. The higher government respect for disappearance, extrajudicial killing, political imprisonment, and torture (higher democracy level), the smaller unemployment rates.

Government consumption, as percentage of GDP, affects positively both, the employment to population ratio and unemployment rate, though, on a long run, government consumption reduces employment to population ratio, and, on average, it increases the long-term unemployment rate. The previous is in line with our

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expectations, as well as with the economic theory. One has to have in mind that observed CEE countries in their transition period were predetermined to conduct expansive fiscal policy, especially in the segment of government consumption. The reasons were different - from the European Union integration processes and the need for infrastructural improvements (intensive capital investments) to anti-cyclical and social policy corrections. Therefore, taking into account the crowding-out effect of fiscal policy – which implies that fiscal policy, on a long run, leads to extinction of the private sector – the reduction of employment and increase of the rate of unemployment, on a long run, were inevitable. So, in general, government consumption, on average, reduces positive labor market outcomes (employment to population ratio and average annual hours worked), and increases long-term unemployment rate and general unemployment rate.

The effects of the other macroeconomic variables on labor market outcomes, are not quite clear. We believe that it is due to the specific macroeconomic policies in different CEE countries. This statement is valid for both, EU and non-EU countries. Moreover, different macroeconomic policies were conducted in all EU member countries, implied in our sample, before their accession. We have tried to solve this problem by using GMM model, where the specific effects of different macroeconomic policies among countries would have been neutralized, but the results were partially successful.

Finally, one can conclude that higher level of democracy induces more positive labor market outcomes. The main conclusion from this paper, which at the same time can be understood as a recommendation for policy makers in observed CEE countries, is that employers have to be influenced to improve the worker rights in their respective countries. Our investigation confirms that higher worker rights have positive impact on the rate of unemployment. Improving workers rights can be done through various mechanisms i.e. imposing minimum wage on a higher level, as percentage from the average pay in the country or industry, or through higher workers participation which is regulated with the European worker's council directive. Regarding macroeconomic

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policies, taking into account the existence of the crowding-out effect, we strongly believe that fiscal prudence is needed.

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Appendix

Table 3. Seemingly unrelated regression (SUR) in panel data set (model 1)

Model		1	2	3	4
Dependent variable		emplp (Employment to population ratio)	lavh log of (average hours worked)	Ltur (long term unemployment)	Unem.rate (Unemployment rate)
		Coef.	Coef.	Coef.	Coef.
L_Worker	Lagged Workers' rights (CIRI)	-0.100	0.058***	-0.80***	-1.49
L_Hergov	Lagged Herfindahl index of government concentration	-0.696*	-0.018*	0.76*	1.03*
L_Physint	Lagged Physical integrity rights index	-0.456***	-0.007**	0.42***	0.60***
L_FH_PR	Lagged Freedom House political rights index	0.313***	0.003*	-0.28***	-0.41***
L_Inflation	Lagged Inflation (CPI)	-0.074***	0.001*	-0.02*	-0.04*
L_logRGDP	Lagged Logarithm of real GDP	3.686***	-0.058***	1.34***	1.67***
L_Gross capital formation	Lagged Gross capital formation (wealth)	2.06E-11***	4.53E-13***	-9.73E-12***	-9.84E-12***
L_Tax revenues as percentage of GDP	Lagged Taxes (% of income)	-0.550***	-0.004***	-0.05	-0.07
C	Constant	30.299***	8.050***	-5.99	-2.99
R ²		0.5887	0.4470	0.2281	0.2187

Note: *** statistical significance at all levels of significance; ** at 5%, * at 10%.

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Table 4. Seemingly unrelated regression (SUR) in panel data set (model 2)

Model		1	2	3	4
Dependent variable		Empl (Employment to population ratio)	lavh log of (average hours worked)	Ltur (long term unemployment)	Unem. rate (Unemployment rate)
		Coef.	Coef.	Coef.	Coef.
L_Worker	Lagged Workers' rights (CIRI)	0.35	0.060***	-1.02***	-1.79***
L_Hergov	Lagged Herfindahl index of government concentration	-0.50	-0.014	0.37	0.43
L_Physint	Lagged Physical integrity rights index	-0.50***	-0.006***	0.38***	0.53***
L_FH_CL	Lagged Freedom House civil liberties index	0.38***	-0.002***	0.01	0.09
L_Inflation	Lagged Inflation (CPI)	-0.08***	0.001*	-0.02*	-0.03*
L_logRGDP	Lagged Logarithm of real GDP	4.57***	-0.052***	0.69	0.75
L_Gross capital formation	Lagged Gross capital formation (wealth)	1.81E-11***	4.61E-13***	-9.67E-12***	-1.02E-11***
L_Tax revenues as percentage of GDP	Lagged Taxes (%of income)	-0.546***	-0.004***	-0.04	-0.056
C	Constant	22.272***	8.011***	-0.88	4.013
R ²		0.5806	0.4420	0.1569	0.1431

Note: *** statistical significance at all levels of significance; ** at 5%, *at 10%.

Table 5. Seemingly unrelated regression (SUR) in panel data set (model 3)

Model		1	2	3	4
Dependent variable		Empl (Employment to population ratio)	lavh log of (average hours worked)	Ltur (long term unemployment)	Unem.rate (Unemployment rate)
		Coef.	Coef.	Coef.	Coef.
L_Worker	Lagged Workers' rights (CIRI)	-0.10	0.052***	-0.35	-0.89***
L_Hergov	Lagged Herfindahl index of government concentration	0.26	-0.007	-0.24	-0.23
L_Physint	Lagged Physical integrity rights index	-0.44***	-0.004*	0.27***	0.39***
L_FH_PR	Lagged Freedom House political rights index	0.26***	0.001	-0.18***	-0.27***
L_Gov.consump	Lagged Government consumption	-0.32***	-0.006***	0.52***	0.67***
L_logRGDP	Lagged Logarithm of real GDP	2.33***	-0.041***	0.61***	0.53
L_Gross capital formation	Lagged Gross capital formation (wealth)	1.94E-11***	4.23E-13***	-7.43E-12***	-6.84E-12*
L_Tax revenues as percentage of GDP	Lagged Taxes (%of income)	-0.56***	-0.004***	-0.06*	-0.08*

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C	Constant	41.60***	7.978***	-4.40*	0.34
R ²		0.5799	0.4749	0.4683	0.4200

Note: *** statistical significance at all levels of significance; ** at 5%, *at 10%.

Table 6. GMM regressions (model 4)

Model		1	2	3	4
Dependent variable		Empl (Employment to population ratio)	Avh (average hours worked)	Ltur (long term unemployment)	Unem.rate (Unemployment rate)
		Coef.	Coef.	Coef.	Coef.
Dependent variables Lag(1)		0.87***	0.76	0.82***	0.96***
Lag(2)		-0.01	-0.17***	-0.20***	-0.39***
Worker	Workers' rights (CIRI)		6.69	0.04	-0.02
Lag(1)		-0.39	-0.31	0.39***	0.26
Hergov	Herfindahl index of government concentration	-0.10	-11.47	0.67***	0.93***
Lag(1)		0.34	-12.70	0.04	0.49
Physint	Physical integrity rights index	0.06	0.56	-0.18***	-0.13
Lag(1)		-0.01	2.32	-0.09*	-0.18**
FH_CL	Freedom House civil liberties index	-0.14***	-0.38	0.10*	-0.06
Lag(1)		-0.09	1.56	0.05	0.19***
Gov.cons	Government consumption	-0.33*	-8.10**	0.41***	0.096
Lag(1)		0.61***	2.18	-0.13	0.252
logRGDP	Logarithm of real GDP	7.68***	22.88	-9.40***	-14.2***
Lag(1)		-6.09**	-99.68**	8.62***	12.8***
Gross capital formation	Gross capital formation (wealth)	-3.76E-12	-2.17E-10*	2.41E-12	-4.39E-12
Lag(1)		4.41E-12	1.47E-10	-3.50E-12	2.21E-12
Tax revenues as percentage of GDP	Taxes (% of GDP)	0.040	1.64	-0.09	-0.25***
Lag(1)		-0.075	-1.19	-0.04	0.11
Constant	Constant	-9.141	1690.427***	9.20	16.87
Sargan test H ₀ : over identifying restrictions are valid ;p-value		0.5944	0.0000	0.6249	0.6249

Note: *** statistical significance at all levels of significance; **at 5%, *at 10%.

UDC: 334.72.012.63/.64:339.187.6(497.7)

**ACHIEVEMENTS AND PERSPECTIVES OF THE LEASING INDUSTRY IN
THE REPUBLIC OF MACEDONIA**

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ABSTRACT

Alternative forms for supporting small business development in the Republic of Macedonia, such as leasing, are relatively small and not developed. Dominant role in the financing the economy are credits offered by commercial banks. Until the beginning of 80-ties, leasing is characterized by import of investment industrial equipment, transport means, various machinery, etc. Afterwards leasing is connected by export of agricultural mechanization, building machinery, railway wagons, mining equipment, etc.

First leasing companies in the Republic of Macedonia emerged in the year 2003, focused mainly on leasing activities in car industry (rent-a-car) and generally concentrated on individuals. Development of the leasing market was tough due to initial difficulties connected with progress of the new financial products such as limited technical and operative skills, lack of know-how in leasing arrangements, weakness and limitation in the legal, tax and other regulative, weak development in the financial market, etc.

KEYWORDS: Leasing, Small and medium size companies, Risk

JEL CLASSIFICATION: G23

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1. LEASING IN SMALL BUSINESS FINANCING IN THE REPUBLIC OF MACEDONIA

Leasing in the Republic of Macedonia is characterized with lack of business and investment climate in the economy, recession in EU, low level of knowledge for the benefiter and advantages in leasing as tool for financing, lack of managerial knowledge in financial management, weak financial basic for entrepreneurs and small businesses, relative higher risk in crediting and inadequate risk management, est.

Other obstacles for the development leasing in the Republic of Macedonia are:

- Ownership psychology;
- Limited technical skills (by providers of the leasing agreements);
- Lack of information for assets;
- Undeveloped secondary markets;
- Problems in financing nonbanking leasing providers;
- Lack of knowhow and/or support by government;
- Undeveloped banking industry.⁴

Major part of obstacles and weaknesses can be overcome in a short or middle term period. However, banking sector and secondary market development is expected in a long period, as in countries with similar level of development. According to data of the National bank of the Republic of Macedonia (NBRM) in the year 2013, 9 leasing were active. Ownership structure in the leasing industry represent 93,5% foreign institutions, comparable with 6,5% domestic institutions participation. Furthermore, ownership structure represent 49,8% of other financial institution, 34,3% banks, 14,1% nonfinancial institutions and 1.5% individuals.

In the year 2008, the number of leasing companies was 8, whereas the number of agreements reached 4007 with total amount of 52.7 million Euros. As result of the world financial and economic crisis as well as domestic factors, in the following years the number of agreements and their values permanently decreases. In 2013 the companies have dominant role in the new agreements (78,8%), whereas the values of

⁴Трајковски, Гоце: Банкарско финансирање на надворешната трговија. Скопје, 2010, p.212.

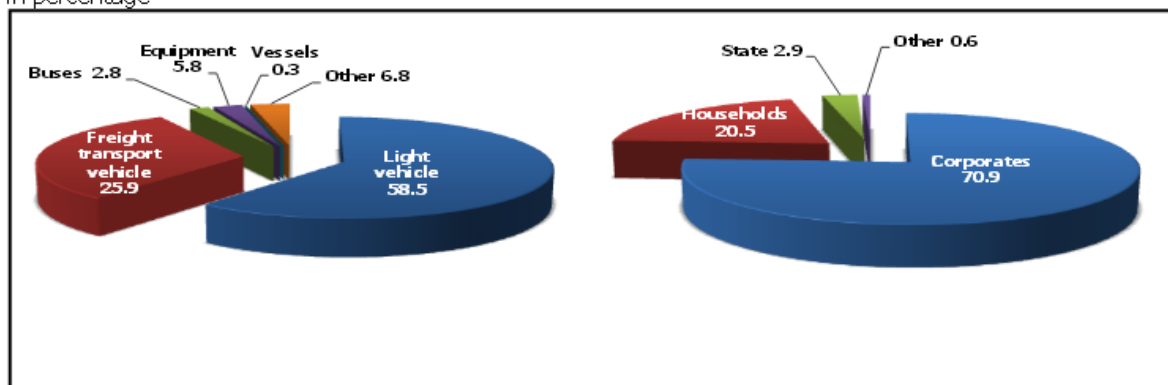
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the agreements is 70,7%. Moreover 80% of the active agreements are scheduled up to 5 years.⁵

The reasons for downward trend in the value of the leasing agreements, apart from the world recession, are based in the inappropriate and changeable legal and tax regulation, declined investment activity and decreased enterprise liquidity. Leasing companies face difficulties for regular charging annuity, canceled agreements prior to finalizing the leasing periods and increased credit risk.

Graph 1.

Structure of the value of the newly concluded leasing contracts, by leasing subjects (left) and sector (right) in percentage



Source: Ministry of Finance.

Financial Stability Report for the Republic of Macedonia in 2013. National Bank of the Republic of Macedonia, July 2014, p.105.

In the structure of moveable assets, the highest participation lies in light vehicles, and it apply to active as well as new agreements. Hence, participation of lights vehicles in the structure of leasing agreements for the year 2009 is 86,7%, in the year 2013 decreased on 72,6%, whereas the participation of freight transport vehicle is increased from 8,4% to 23,1% respectively. In the active leasing agreements, participation of the light vehicles in the year 2009 is 89,1%, in the year 2013 is decreased on 77,3%, whereas freight transport vehicle increased their participation from 5,7% on 16,7%. The decreased tendency in number of leasing agreement with light vehicles can be

⁵Financial Stability Report for the Republic of Macedonia in 2011, 2012 and 2013. National Bank of the Republic of Macedonia.

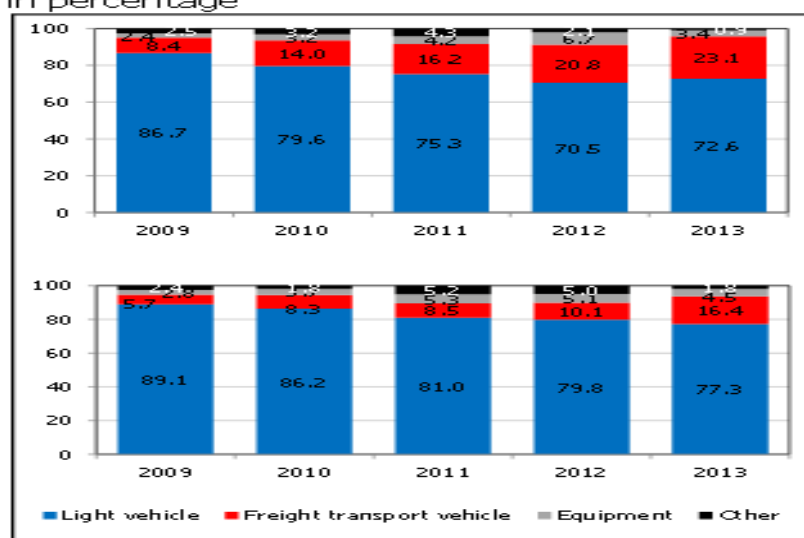
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elaborated by increased import of used light vehicles and their relatively low price. In some matter it increases the number of canceled leasing agreements. In general, the increased participation of the freight transport vehicle (three times in the period 2009-2013) contribute to the increase leasing for business purposes in the area of trade and transport.

However it is notable the low level of leasing agreements for equipment ranging from 2,4% up to 3,4% with tendency for declining. For example, in developed countries, equipment has major participation in the activities of the leasing sector, arising as significant factor for production, productivity and export. Moreover the number of leasing agreements in the real estate business is minor.

Graph 2.

Structure of the newly concluded (top) and active (bottom) leasing contracts for leasing of movables in percentage



Source: Ministry of Finance.

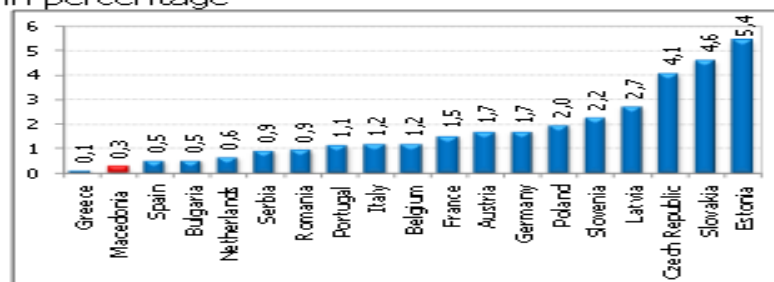
Financial Stability Report for the Republic of Macedonia in 2013.
National Bank of the Republic of Macedonia, July 2014, p.106.

According to the estimation of the NBRM, although the leasing sector started with fast pace of development within the financial sector, today is not an important additional source of business finance. Tendencies for decreasing the number and value of leasing agreements contribute to declining trend of leasing sector participation in the GDP.

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Graph 3

Share of the value of the newly concluded leasing agreements in GDP in percentage



Source: Ministry of Finance, web site of the Federation of the National Leasing Associations in Europe, Eurostat. The data refer to 2012, except for Macedonia which refer to 2013.

Financial Stability Report for the Republic of Macedonia in 2013.
National Bank of the Republic of Macedonia, July 2014, p.104.

According to previous, we can summarize that the significance of the leasing sector in the economy of RM is minor. This sector has lowest implication for the domestic economy compared to the countries in the region and EU, except Greece. For example, the newly leasing agreements in relation to the GDP in the year 2012, participation of RM is 0,3% and it is for 18 time lesser in comparison to Estonia, whereas 15 time lower than Slovakia.

Minor significance of the leasing sector in our economy can be foreseen also by the financial performances of the leasing companies. Table 1 demonstrates the data of the balance sheet for leasing companies in Macedonia in the year 2012 and 2013.

Table 1.

Balance sheet of the leasing companies

Items	In millions of Denars		Structure in %	
	2012	2013	2012	2013
Claims for financial leasing	4,261	3,399	61.7%	56.7%
Fixed assets	920	872	13.3%	14.6%
Loan	1,009	983	14.6%	16.4%
Deposits	176	206	2.5%	3.4%
Other assets	541	530	7.8%	8.8%
TOTAL ASSETS	6,907	5,990	100.0%	100.0%
Borrowings	5,007	4,193	72.5%	70.0%
Reserves	1,255	1,260	18.2%	21.0%
Other liabilities	631	483	9.1%	8.1%
Equity and reserves	14	54	0.2%	0.9%
TOTAL LIABILITIES	6,907	5,990	100.0%	100.0%

Source: Ministry of Finance.

Financial Stability Report for the Republic of Macedonia in 2013. National Bank of the Republic of Macedonia, July 2014, p.106.

Account receivables for financial leasing has dominate participation in the structure of total assets with participation of 61,7% in the year 2012 and 56,7% in the year 2013. High level of receivables for financial leasing demonstrate high level of risk exposure of the leasing companies, which is result of weak credit analysis and inappropriate risk management. Accounts payable of leasing sector based on credits is estimated as relatively high (participation in the total liabilities of 72,5% in the year 2012 and 70,0% in the year 2013). Main source for financing of these companies are loans from abroad.

According to the estimation of the NBRM, leasing sector has minor influence in the stability of the total banking and financial sector. Hence, deposits of the leasing companies within the domestic banks represent only 0,1% of the deposits of the total banking sector and their participation in the total assets in the banking sector is 6%.

2. FINANCIAL AND OPERATIONAL LEASING

According to the International Finance Corporation (IFC), in developing countries is easier to introduce financial leasing. Law for leasing often is adjusted to regular laws for rent as in the case of the Republic of Macedonia.

Operational risk is not regulated with a particular law. Hence, according to the IFC, financial leasing has priority in development. However, this does not underestimate the significance of the operational leasing. Experience indicates that it is easier to introduce leasing as simple product in the financial sector in developing countries, if the leasing industry is focused on the financial leasing. Operational leasing should be offered as a product of leasing companies, once the business sector will adjust to financial leasing and when participants in leasing arrangements, particularly seller of equipment and sophisticated leasing consumers, will require tax based products.⁶

⁶ Leasing in Development. Guidelines for Emerging Economies. IFC, 2009, p.25.

3. RISKS OF LEASING ARRANGEMENTS IN REPUBLIC OF MACEDONIA

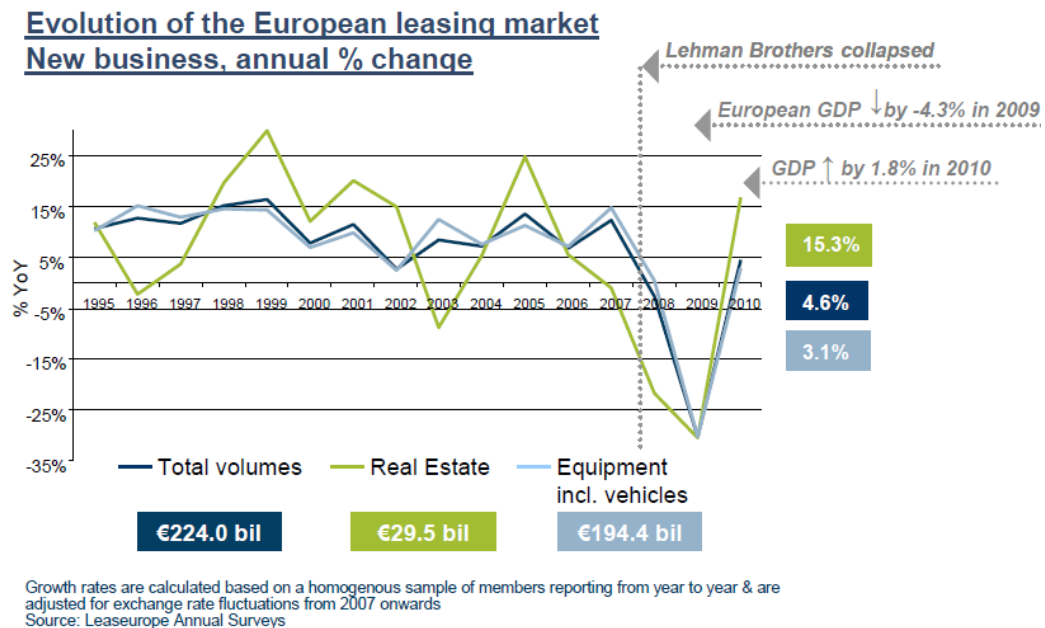
Risks facing the participants in the leasing arrangements are essentially the same as the risks facing other business in their everyday operations. The extent of risk damage depends on how participants in leasing arrangements will avoid, reduce or delay them. The risks of the leasing arrangements in Macedonia are also associated with the way of the use, storage and maintenance of the asset in the lease agreement. It is important whether the lessee successfully operates with the asset and whether there will be cash flow for repayment the agreed installments.

The analysis of the concluded leasing agreements indicate relatively poor range of leasing assets where the dominant share have the light vehicles and freight vehicles with over 90%. The structure of the vehicle changes with the growth in the share of freight vehicles (5.7% in 2009 to 16.4% in 2013) at the expense of light vehicles (share of 89.1% in 2009 and 77.3% in 2013). Dominant share of leasing of vehicles can be connected to the high participation of small businesses in the active companies in the field of wholesale and retail trade, repair of motor vehicles and motorcycles (95% of the total number of active enterprises) and in the transport sector and storage (99.2% of all active enterprises). Participation of equipment in lease arrangements is quite low (in the analyzed period, it amounted to 2.8% in 2009 and 4.5% in 2013). As a result of the structure of assets subject to leasing agreements, their individual value is low, and deadlines have average of about 5 years. There is lack of leasing expensive equipment and facilities in the long term (the most expensive transactions was the leasing of passenger aircraft). Leasing contracts represent minor part in GDP of only 0.3%, so the risks in the leasing sector have a marginal impact on the stability of the financial sector and the national economy. According to global rating agencies the risk of our country is assessed by B++. Similar assessments of risk are provided by the World Bank, the International Monetary Fund and the European Commission. However, within the general risks, one should take into account the impact of developments in the framework of international economy. Thus, the crisis and the recession in the EU have a strong impact on the performance of the economy of the Republic of Macedonia and

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on the performance of the sector of small businesses. The problems in the financial sector of the EU countries are manifested on leasing companies in our country, which are almost entirely owned by foreign companies. This means that developments in the leasing sector in the EU is declining, and it reflect on the volume and value of leasing contracts in the Republic of Macedonia, which also tend to decline.

Graph 4. Impact of the Crisis on European Leasing



Source: Leaseurope. A view on the European leasing market and vehicle theft, 2011.

Risks affiliated to the small businesses risks represent the major part of general risks. Small businesses in the Republic of Macedonia, generally, do not have revised accounting statements. Similar to the situation in many developing countries, financial statements are not prepared on regular base, for example, for several months or quarters, and not for the entire year. Also, business history spans over a year or two, and sometimes of neither one year. Consequently, leasing companies face difficulties to better assess and determine the credit risk of the user. Particularly constraining issue represent the low financial power and (in)liquidity of small businesses as users of leasing, that reflects their ability to pay lease installments in accordance with the agreements.

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Credit risk represents the main risk of the leasing sector in the country. This risk tends to increase with impact on the operation of leasing companies. The main reason for the relatively high credit risk is poor risk management of leasing companies which enter into leasing arrangements without deep short and long-term financial and business analysis of the leases, on the one hand, and insufficient cash flows.

Finally, another reason for the high credit risk in the leasing sector is the regulatory and supervisory function. Namely, supervision is seen as relatively weak and with low levels of transparency, although certain improvements are made in the area of licensing and reporting. According to the estimates of the NBRM, the tendency of decrease in leasing sector activity will continue, primarily due to the measures for financial discharge of parent banking groups in the EU and the closure of non-strategic markets, whose members are mostly from domestic leasing companies.⁷

The risk of liquidity/solvency is quite present in our leasing practice. Analysis of the activities of leasing companies indicated that they face canceling contracts and high level of receivables. This risk is directly related to the risk of efficiency and risk of profitability. The basic risk of leasing companies in the Republic of Macedonia derives from legal ownership of the assets, subject to the lease agreement. Legal risk is associated with not effective judiciary in resolving disputes in leasing arrangements. This risk discourages leasing companies entering into leasing arrangements taking into account the long procedure, cost and uncertainty of litigation. During the leasing contract, the lessee can damage, destroy or refuse to return the asset. Damage, depresses the possibility same asset to be leased or sold at acceptable price for the lessor. Moreover, installments for the damaged asset are reduced, and thus the returns that generates the lessor (the leasing company) are also minor.

There are a large number of users of leasing in Republic of Macedonia that do not meet their obligations under the lease agreement regarding the use of leasing asset. It is associated with unprofitable business and the lack of regular cash flows. Here are

⁷Financial Stability Report for the Republic of Macedonia in 2012. NBRM, 2013, p.115.

most of the reasons for cancellation of leasing contracts. Cancelled agreements mean expenses and unrealized gains on leasing companies.

4. PERSPECTIVES OF LEASING FOR SMALL BUSINESSES AND THE ECONOMIC DEVELOPMENT OF THE REPUBLIC OF MACEDONIA

In developing countries, and in the Republic of Macedonia, there are large amounts of real and financial capital and development opportunities. One of the ways to finance the development in these countries is the leasing. Very important is a good institutional framework that will provide competition and business initiative. The creation of a good legal framework, laws that are mutually compatible, efficient state administration and judiciary, are very important for developing the entrepreneurship.

In recent years, in the Republic of Macedonia, there have been made major developments in the area of creating favorable conditions for business. The evidence is the various rating lists for competitiveness, the business conditions as well. In the upcoming years, there should be expected further reforms and improvements of the business climate that will affect the development of the leasing. An important aspect is also the psychology of ownership, taking in consideration, that it is better to own the asset, than to lease it and pay rent for it. The tradition for transferring the property and the real estate from one to another generation still exists. This contributes the banking credit to be more attractive than the leasing.

The necessity of developing the leasing in the Republic of Macedonia is indisputable. The benefits of the application of leasing, which are numerous and indisputable, and the experience of many countries shows it. The sooner we create favorable conditions for the application and development of leasing, the greater will be the benefit to the national economy and the employment.

In the process of shaping the development of leasing, there should be used the experience of the developed countries and the successful examples of transition countries. For example, the International Finance Corporation (IFC) and The International Labor Organisation, have extensive experience and practical knowledge

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for the development of the leasing sector. The cooperation with the IFC, which is a member of the World Bank group, and the implementation of its recommendations and guidelines, can help in the process of developing the leasing sector. Under the influence of this institution, in certain countries, the leasing has briefly achieved rapid growth with multiple benefits for the national economy. As it was previously indicated, despite the Law on leasing, the issue of leasing should be amended, developed and matched with other areas, especially regarding taxes and accounting. Undoubtedly, the tax treatment is one of the most important prerequisites for the success of leasing arrangements and its profitability. The same applies to the consistent application of the Standard 17 of International Accounting Standards concerning the accounting of the leasing. Issues of particular interest are the return of property, bankruptcy, registration and definition of financial leasing. Correctly shaped solutions in these areas are important for the development and successful application of the leasing. Some of these assumptions have already been realized, and other part of them can be realized in relatively short term period. However, proper development of banking and secondary financial markets can be expected in long term.

It is indisputable that changing the structure of leasing assets, with greater participation of equipment, will contribute to accelerating the manufacturing sector, and of course, the employment. Enriching the structure of leasing is related to the change of the portfolio (concentration), where, the light vehicles and trucks dominate. The expansion of the structure will reduce the portfolio risk of leasing providers, which arises of the high concentration (usage) of leasing arrangements of a group of users, mainly individuals, from the same industry (cars). The diversification of users and the leasing assets is a manner to avoid and/or reduce the portfolio risk. However, the structure of the offer of leasing assets is mostly determined by the demand which creates the current status of the active leasing contracts. Also, there has to be taken in mind that the increase of the demand for leasing assets is related to many macro-economic and micro-economic factors and changes of the regulation.

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Particularly is important the development of the leasing of equipment. In the area of mining engineering, non-metal, as well as in the agriculture, there are possibilities for application of the leasing. For example, the worldwide experience suggests the application of leasing in the area of mining engineering, when large mining companies engage small firms to work with certain equipment under lease. This practice is often used and it proved to be functional. Small businesses quickly adapt to the large companies' needs and they easily cope in finding the necessary equipment, which is often numerous and diverse.

The leasing companies in our country are mostly owned by foreign leasing companies which have branched business activities in several countries. It can be assumed that they are able to offer a broader range of leasing assets especially in the equipment sector. It is realistic to assume that they can meet the demand for leasing equipment if there are entrepreneurs with sound business plans. In the Republic of Macedonia there are several industrial zones where foreign companies or their subsidiaries are located and operate. One of the perspectives for development of leasing is the inclusion of small businesses in the programs of these companies through leasing of modern equipment that meet their needs.

The leasing is recommended as business model for individual entrepreneurs, for micro businesses, and for medium enterprises in the countries where the high interest rates and the difficulties in obtaining credit, are an obstacle to purchase a business asset in terms of not having their own cash. Therefore, it is recommended the creation of programs for micro financing of individuals entrepreneurs and small businesses. In that sense, the micro leasing is an instrument for the development of micro-financing.

Micro-financing provide finance to poor individuals as well as poor companies, most of them "start-up's", which allows the purchase of small business assets and raw materials which are further processed into finished products and are sold for a small profit. Because of these attributes, the micro-leasing has perspectives to be applied and

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developed in our country, where there is a high unemployment rate and significant rate of the gray economy.⁸

Special area of development of leasing in the Republic of Macedonia is the agriculture. The leasing would mostly refer to the provision of agricultural equipment. The main problem the leasing providers would face with is the great diversity of agricultural equipment, as well as the assessment of the creditworthiness of the users who. The leasing providers should be aware of these specificities and to properly structure the leasing rent. Particular obstacle for the introduction of leasing in agriculture is the provision of a deposit by the user.⁹

5. CONCLUSION: RECOMMENDATIONS FOR USE OF THE LEASING IN SMALL BUSINESSES FINANCING

Recommendations for development of leasing in the Republic of Macedonia relate to different fields such as:

- **Further improvement of the macro and microeconomic business climate.** The economic growth and the growth of investments is an assumption for increased use of leasing for business projects financing, primarily the leasing arrangements for equipment.
- **Enhancement of business and management skills of small businesses for application of leasing.** It is related to the knowledge of strategic management and methods of capital budgeting (the concepts of net cash flow, discounted net value and cost of capital). This is connected with good leasing projects and better use of financial and human potentials.
- **Improvement of the leasing regulation.** Leasing is basically a financial instrument which operates within its legal framework. The existing local legal

⁸Наневски, Благоја: Микро финансирањето – основа за развојни стратегии на семејните бизниси и на вработувањето. Објавено во: Стопански и регионален развој, семејни бизниси и здружување. Економски институт-Скопје, Здружение за одржлив развој-Скопје и Фондација „Фридрих Еберт“ Скопје, Скопје, 2003, р.99.

⁹Fletcher, Matthew and others: Lesing in Development. Internacional Finance Corporation, Washington, D.C. 2005, pp.12-14.

framework, prejudice the implementation and development of the leasing. The success of the leasing depends on how the legal framework for leasing relies on the legal framework of finance.

- **Changing the tax legislation** by removing the existing solutions that discourage the leasing and introduce solutions which encourage it. Changes and incentive rates should be considered for the VAT, property tax, sales tax, real estate tax and customs. The tax treatment has a major impact on the cost of leasing arrangements. But, it is necessary tax benefits to be moderate, and not to cause distortions on the domestic market by negative end effects on the overall financial sector.

This means that the main goal of the tax preferences should be the growth of investments, and not only stimulating the leasing sector. The experience has shown that any preferential tax treatment of leasing should have a limited duration and the period to be announced in advance. There should be been taken in consideration the overall tax system.

- **The leasing asset to be partially or fully exempt of customs duty.** This cost along with the associated costs of customs control can be a significant barrier to the import of business assets, which makes an obstacle to import modern equipment and technology, and thus to increase the productivity in economy.
- **Accelerated depreciation on leasing assets** encourages the investment in fixed assets through leasing in order to receive possible tax benefits. In general, accelerated depreciation should be for all types of fixed assets.
- **IAS Standard 17 to be the basis for defining the national leasing legislation, including accounting for leases:** (1) Standard 17 provides a framework and guidance for the development of the domestic leasing legislation, and (2) Although the application of IAS-17 may be different in different countries, the application of IAS is an objective for all countries. This means that, when

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IAS-17 is the basis for the domestic leasing legislation can be build good standards for this legislation.

- **Regulation of the non-banking leasing companies.** The supervision of the leasing as an activity of the NBRM should be designed in accordance to our specific conditions. If the leasing is financed by an institution which is already under the supervision of the NBRM, than the implementation of the supervision is necessary.
- **Developing the banking sector and the secondary financial markets.** Some changes in this area are available on a long term basis, but there a part of this regulation to be improved now.
- **Providing deposit.** This especially balks the usage of the leasing in the agricultural sector and by the micro companies.

The leasing providers, which are mostly branches of foreign leasing companies, should be encouraged to offer leasing arrangements for equipment for involving the small businesses in the foreign companies' programs within the technological-industrial zones in many towns in the Republic of Macedonia. The role of the leasing providers should be counseling and related to the election of equipment, trainings, monitoring, as to other issues that successful leasing depends on.

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**CUSTOMER DUE DILIGENCE – FOCAL POINT OF THE ANTI-MONEY
LAUNDERING PROCESS**

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ABSTRACT

Money laundering activities may have huge negative effects on an entire national economy and its financial institutions. Involvement in these activities can paralyze the political and economic institutions of a certain country, destabilize the integrity and stability of financial institutions, stimulate tax evasion, discourage foreign investments, weaken purchase power of the population and stimulate unfair competition on the market. Negative impact of the money laundering activities requires from all relevant subjects (financial institutions in particular) to take certain measures and activities in order to avoid their potential exposure to reputational, operational, compliance and concentration risk. That's why the anti-money laundering (AML) process draws huge attention in scientific and experts' community. It is also very important for legal entities and individuals who have regular banking activities and take care about safety of their deposits.

Focal point of the AML process is customer due diligence (CDD). CDD is entirely oriented towards the clients. It's all about "knowing a customer" in each and every meaning of those words. CDD measures and activities comprise of client's identification and verification of its identity, identification and verification of identity of beneficial owner, obtaining information about client's business activities, geographic area, financial situation etc. Only exhaustive information about every client may determine a proper risk category for a certain client and adequate AML measures and activities by the financial institution.

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The process of prevention of money laundering is remarkably complex and demanding. It contains many variables that must be taken into consideration in order to achieve the ultimate goal – establishment of effective and efficient anti-money laundering (AML) process.³

Commercial banks' day to day activities mean running of business relations with different types of clients. Each client has different needs of banking products and services, different level of liquidity, different habits. It is estimated that from 95% to 99% of bank clients run legitimate businesses or have legitimate needs of banking products and services. But those 1% to 5% of clients who try to use the bank for their illegitimate activities requires from each bank to take active part in the AML process. Implementation of adequate AML process requires a lot of resources from the bank. It takes time, it takes money, and it requires high level of knowledge⁴ from banking staff. It's quite understandable having in mind the complexity of the AML process.

Customer due diligence (CDD) has focal point in the AML process. CDD means deep and though knowledge of the client's occupation, business activities, geographic area that he comes from, banking products, services and transactions that are used by the client⁵. CDD means "knowing your customer" to that level so a bank can always know what to expect from the clients when it comes to use of certain product or performance of certain transaction. Each product or service required by the client that is unusual or each transaction that differs from previous types of transactions performed by that client may initiate further activities by the bank. A bank must reach a reasonable certainness that its clients are not involved in money laundering activities.

³ International monetary fund: "The IMF and the fight against money laundering and the financing of terrorism", March 2015, www.imf.org.

⁴The World Bank Risk Assessment Methodology, 2013.

⁵Гоце Трајковски: „Спечување на перење пари кај финансиските институции“ август 2011, стр. 53.

Customer due diligence begins with the first contact between a client and a bank. The first step taken by the bank is to identify the client and to verify its identification. Then a bank must determine whether the client acts by himself or there is a holder of the rights behind him. The bank must also identify and verify the beneficial owner of the client.⁶ Identification of the client is performed through certain documents which serve as a proof of the client's identity. Legal entities are identified with their certificates of incorporation into certain national agency (court, chamber of commerce etc.). Individuals are identified with their IDs, passports etc.

Documents that are used for identification of the legal entities must contain name of the subject, its seat, business activity, owners or managers of the legal entity etc. On the other hand, documents for identification of individuals must contain name, address and other elements that are necessary for identification of a certain natural person.

There are some dilemmas when it comes to the verification of the client's identity. The first dilemma refers to the timing of verification. Some experts think that identification of the client and verification of its identity happen in the same time. It's the moment of submission of the identification document to the bank. Other experts have opinion that verification happens after the identification. By verification they mean checking the independent and reliable sources which can confirm or deny the client's identity. Second dilemma is related to the sources that can be used for verification of the client's identity. Banks usually use internet when they want to find or check some data. Internet is independent source of information, but it is not always reliable. Anyone can place any information on internet. Concerning other sources, like contacting the issuing authority of a certain document are more reliable. However, these sources are more expensive, especially when it comes to contacting the foreign authorities. Therefore, many banks are using internet for verification, although it's not always recommended source.

⁶ Bank for international settlements: "Sound management of risks related to money laundering and financing of terrorism", January 2014, p. 7.

A client is not always in position to be physically present in a bank. He can establish a business relationship through a proxy.⁷ In that case a bank is obliged to identify and to verify the identity of a principal (holder of the rights) and of a proxy as well. It is not always an easy case, especially when the client is a legal or natural entity located abroad. In that case identification and verification of identity of the principal becomes a complex process, so many banks are not always willing to establish a business relationship, especially when a principal is a foreign natural person. Absence of managers of the foreign companies while opening an account in a bank is understandable, so they authorize a proxy to establish a business relationship on behalf of them. But absence of foreign natural persons very often means increment of risk, so banks are more comfortable when foreign individuals establish a business relationship in their own name.

It is worth to be mentioned that all dilemmas mentioned previously when verification of identity of the client is discussed apply to the establishment of a business relationship through a proxy. Perhaps the most important and most difficult task for the banks is identification and verification of identity of beneficial owner. Each bank is obliged to determine who the beneficial owner of the client is, in order to take adequate measures toward a certain client. If bank is not sure or doesn't know the beneficial owner of a client, all the measures taken in the AML process may not produce the expected results.

Persons involved in money laundering try to disguise⁸ the ownership or managerial structure of the legal entity. Their efforts in this area are concentrated in finding a certain forms of legal entities or certain countries that don't allow revealing of identity of the beneficial owner. Speaking about forms of legal entities, the situation is complicated in several areas: legal arrangements, fiduciary ownership, bearer shares etc. Legal arrangements (trusts and other forms) are immanent characteristic of jurisdictions under Anglo-Saxon law. When these forms of legal entities become a client

⁷Council of Europe, MONEYVAL: "Report on fourth assessment visit, anti-money laundering and combating the financing of terrorism – Macedonia" April 2014, p. 131.

⁸Financial Action Task Force: "Transparency and beneficial ownership", October 2014, p. 6.

of a certain bank, that bank is obliged to look not only for the owners of the shares, but also for the voting rights and other rights that derive from those shares.

Fiduciary ownership is usually related to the stock exchange activities. In this case, an investment fund is a client of a brokerage house. The brokerage house may take all the CDD activities concerning a certain investment fund, but it may not find out who places money into the investment fund in order to purchase securities at the stock exchange market.⁹

Bearer shares make CDD activities practically impossible. In this case, a bank or a brokerage house is not in position to identify the owner of those shares. If a client's identification cannot be performed, it's unimaginable to speak about further CDD measures. However, due to the pressure of some international organizations or bodies (OECD, European Union, Financial Action Task Force etc.), most countries are obliged to create registers where the owners of bearer shares will be listed. These registers make CDD measures slightly easier to be undertaken, because a bank or a brokerage house can look into those registers and find the owners of bearer shares.

Certain forms of legal entities are not the only problem in the area of beneficial owner identification and verification of its identity. Many countries support the banking secrecy. Banks located in these countries do not exchange data with their correspondent banks in other countries. It means that when a non-resident wants to open an account in a certain bank, that bank may ask for data from its bank in its home country. If a native bank of that client doesn't exchange data, CDD activities will be hard to be implemented from a bank where the client is a non-resident. Banking secrecy is not the only problem. In many countries (tax havens or off-shore countries), there is a lack of ownership transparency.¹⁰ In these countries, more companies are registered on the same address, and quite often the person stated in the act of incorporation is not the real beneficial owner. In some cases, companies are registered by the attorney at law or public notary and the name of the owner remains unknown.

⁹International Organization of Securities Commissions: "Report on money laundering", p. 7.

¹⁰Financial Action Task Force: "Transparency and beneficial ownership", October 2014, p. 7.

On the other hand, international standards and regulations require from banks to identify the beneficial owner and to verify its identification. Same documents used for client's identification and verification of identity apply in this case and same dilemmas mentioned earlier remain. However, it is always more difficult to identify the beneficial owner than the client itself, especially having in mind the physical absence of the beneficial owner while establishing a business relationship.

There are some exceptions in the rules for identification of the beneficial owner of the client and verification of its identity. For instance, when the client or the owner of the controlling interest is a company listed on a stockexchange and subject to disclosure requirements (either by stock exchange rules or through law or enforceable means) which impose requirements to ensure adequate transparency of beneficial ownership, or is a majority-owned subsidiary of such a company, it is not necessary to identify and verify the identity of any shareholder or beneficial owner of such companies. The relevant identification data may be obtained from a public register, from the client or from other reliable sources.¹¹

Once the client and its beneficial owner are identified and their identities are verified, the next task for the bank is to determine the purpose of establishing a business relationship. In situation where each bank strives to get more clients, examining of the purpose of establishing of business relationship seems contra productive. But that's only the first impression, because making profit must not be the only goal for the bank. A bank must take care about potential operational, reputational and compliance risk and therefore must answer the question why a certain legal entity or natural person wants to become a bank's client.¹²

It's not easy to determine the purpose of establishing a business relationship. Every client (or potential client) has legitimate needs for banking products or services. Even those clients with illegitimate needs, try to present themselves as every other regular client to the bank. Identification and verification of identity of the client and its

¹¹ The FATF Recommendations, February 2012, p. 63.

¹² Bank for international settlements: "Sound management of risks related to money laundering and financing of terrorism", January 2014, p. 2.

beneficial owner may help a bank to make difference between regular clients and those who try to launder their money, but still, this is only the first step. Many other questions need to be answered in order to create a complete picture of the client.

One of those questions is why a certain client wants to establish a business relationship with a certain bank. This question is very important especially when the clients from remote geographic areas want to come to a bank. Speaking about remote areas, interpretation differs from country to country, having in mind the magnitude of a certain country. However, even in small countries, if a client has many banks in his hometown (or seat) it is always a question why that client comes to another town. This issue is even more complicated with non-residents who are registered and run businesses abroad and want to establish a business relationship with a domestic bank. Therefore, a bank must obtain information about the client's business activities. Such information can be obtained from registration documents for legal entities. Concerning the natural person, a bank can ask for a statement from its client where he can provide information about his occupation or employer. What so ever, not every legal entity has precisely defined business activity. Registration agencies (chambers of commerce, registers, courts etc.) will record a specific business activity of a client according to a certain national classification of activities. However, a business activity of a certain client may be more specific and hard to include in a usual scheme of activities.

Special attention in this area should be paid to non-profit organizations whose business activities are not always precisely defined. In that case, it is very hard to perform CDD measures, because a comparison between client's activities from one side and banking products, services and transactions from the other side cannot be made without facing a lot of problems. Banks must pay special attention to this kind of clients (with imprecisely defined business activities). Sometimes, no matter how deep and thorough CDD measures are¹³, positive results cannot be achieved.

Besides identification of client's business activities, other features must be determined as well. One of those features is client's geographic area. Information

¹³The World Bank: "Use of the anti-money laundering tools to combat corruption", 2015, course.

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where the client comes from will enable a bank to make further analysis about client's geographic risk. This is important because some countries allow non-transparent ownership or managerial structure of the client, shell companies' or shell banks' activities on their territory, do not determine or input the clients' business activities in its registration act etc. These issues increase the geographic risk of a certain client, so a bank must decide whether to enter with a business relationship with a certain client or not and what CDD measures must be taken.

Next topic that has to be analyzed is client's financial situation. It is very important to make a difference between source of funds and source of wealth.¹⁴ Source of funds refers to current transaction of the client. If a client wants to make a transaction, a bank will check whether that client has money on his account or he borrowed money from somewhere else (took a loan, for instance). On the other hand, source of wealth is much broader term. It refers to the total financial situation of the client, sources of its incomes and channels of its expenditures. In order to get a broader picture, banks must obtain balance sheets, income statements and cash flow statements while establishing a business relationship with a client. These financial reports will help banks to know what kind of transactions should expect from the client and what usual size of those transactions should be. On the bottom line, financial statements may lead a bank to a conclusion what type of banking products and services can be provided to a certain client.

Establishing a business relationship is only the first part of performing the customer due diligence activities. Client must be followed on a permanent basis.¹⁵ During the business relationship (which may last from several days to many years), many of the client's characteristics may be amended. For example, beneficial owner may be replaced with another one, business activity may be modified, and financial condition may be improved or worsened. Therefore, a bank is obliged to monitor client's

¹⁴Financial Action Task Force: "Risk based approach for the banking sector", October 2014, p. 20.

¹⁵Bank for international settlements: "Sound management of risks related to money laundering and financing of terrorism", January 2014, p. 10.

activities and transactions on a regular basis. Frequency of monitoring depends on the risk of the client – high risk clients are monitored more frequently and vice versa.

Based on the amended characteristics of the client and as a result of the permanent monitoring of its activities and transactions, the depth of CDD measures may vary. A bank is obliged to implement all CDD measure mentioned previously, but extension of those measures will depend on the risk of the client.¹⁶ If a client comes from a high-risk geographic area, its business activity is vulnerable to money laundering schemes or its products and transactions enlarge a suspicion that something is wrong, CDD measures will be intensified and performed more frequently. On the other hand, if a client with its regular activities and transactions performed in a bank doesnot arise such suspicion, then CDD measures will be taken on a medium-term or long-term basis.

If a bank, during the establishing a business relationship is not in position to execute all CDD measures and activities, it is obliged not to establish a business relationship. If that happens during the business relationship, a bank is obliged to terminate such business relationship. Banks may rely on third parties¹⁷ who can perform CDD on behalf of them. Third parties may be banks within the same financial group or other banks outside that group. It is very important that third parties apply anti-money laundering policies on a satisfactory level. When relying on third party, a bank has responsibility for performed CDD measures in front of the authorities.

Type and scope of CDD measures must be closely related to the magnitude of risk that customer and its activities impose to the bank. In case where the risk of money laundering is low, banks are allowed to apply simplified CDD measures. Lower risk can be imposed by the following factors:¹⁸

- Customer risk factors;
- Product, service, transaction or delivery channel risk factors;
- Country risk factors.

¹⁶ГоцеТрајковски: „Спречување на перење пари кај финансиските институции“, август 2011, стр. 56.

¹⁷Financial Action Task Force: “Risk based approach for the banking sector”, October 2014, p. 18.

¹⁸ The FATF Recommendations, February 2012, p. 66.

Customer risk factors include financial institutions and DNFBPs who have effectively implemented FATF Recommendations. These factors also include public companies listed on a stock exchange with adequate transparency of beneficial ownership. Public administrations or enterprises are also included under these factors.

Product, service, transaction or delivery channel risk factors comprise of life insurance policies with a low premium, insurance policies for pension schemes if there is no early surrender option and the policy cannot be used as collateral¹⁹ and financial products or services that provide appropriately defined and limited services to certain types of customers.

Country risk factors include countries identified by credible sources, such as mutual evaluation or detailed assessment reports, as having effective anti-money laundering systems and countries identified by credible sources as having a low level of corruption or other criminal activity.²⁰

On the other hand, in cases of high AML risk²¹, enhanced CDD measures have to be taken. High AML risk may be imposed by following factors:²²

- Customer risk factors;
- Country risk factors;
- Product, service, transaction or delivery channel risk factors.

Customer risk factors, among others, include non-residents, legal persons or arrangements in certain situations and companies with nominee shareholders or bearer shares. Country risk factors refer to countries with high level of corruption²³, countries with inadequate systems for money laundering prevention or countries that are subject to sanctions or embargos. Product, service, transaction or delivery channel risk factors comprise of private banking, anonymous transactions, non-face-to-face business

¹⁹The FATF Recommendations, February 2012, p. 66.

²⁰ The FATF Recommendations, February 2012, p. 67.

²¹ Bank for international settlements: "Sound management of risks related to money laundering and financing of terrorism", January 2014, p. 9.

²²The FATF Recommendations, February 2012, p. 65.

²³The World Bank: "Use of the anti-money laundering tools to combat corruption", 2015, course.

relationships or transactions and payment received from unknown or un-associated third parties.²⁴

Customer due diligence (CDD) is focal point of the whole anti-money laundering (AML) process. CDD measures and activities enable every commercial bank to become familiar with every client, its ownership and managerial structure, as well as banking products and transactions that are used by the client. Efficient and effective CDD process means taking adequate AML measures – comprehensive clients' analyses which lead to conclusion whether a certain client is running a regular business or it is involved in money laundering activities. That's the only way a commercial bank can protect itself from operational, compliance, reputational and concentration risk that may become effective, if a bank fails to implement adequate CDD measures and activities. The AML process is active and ongoing process. It faces challenges on a permanent basis. Nowadays and in the near future the enforcement of the AML process (and performance of CDD as a focal point of that process) will be subject of essential amendments. Technical compliance of the banks' activities with the laws and by-laws will remain an important element in the future, but fundamental attention will be paid to the effectiveness issues. What does it mean?

It means that risk-based approach will be modified. Performing CDD client by client is not enough anymore. National and sectorial risk assessments have to be implemented in order to define money laundering and terrorist financing threats, as well as national and sectorial vulnerabilities to these threats.²⁵ Once the threats and vulnerabilities are located, certain action plans have to be executed in order to face those threats and overcome the vulnerabilities. The other issue is defining an aggregate risk of a certain bank. Aggregate risk depends on the regulatory framework, type of clients, banking products and services etc. Once the aggregate risk is defined, each bank will be in position to properly allocate its resources in order to implement suitable CDD measures towards certain type of clients.

²⁴The FATF Recommendations, February 2012, p. 66.

²⁵The World Bank Risk Assessment Methodology, 2013.

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10. Гоце Трајковски: „Спречување на перење пари кај финансиските институции“ август 2011.

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ORGANIZATIONAL ALIGNMENT AS A MODEL OF SUSTAINABLE DEVELOPMENT IN THE PUBLIC SECTOR IN THE REPUBLIC OF MACEDONIA

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ABSTRACT

This article presents a theoretical model for organizational alignment as well as an example of practical application of the model in one public institution in the Republic of Macedonia. Organizational alignment is a complex and hard to define concept and there are different theoretical views. However most of the definitions outline the organizational culture, the values and structure and strategy as main elements. Therefore the current theoretical model, Vox Organizationis, proposes that the organizational culture as seen by the employees and the values of the organizational leader as non-formal aspects of the organizational functioning, should be aligned with the strategy, structure and policies of the organization which represent the formal aspect. The paper presents a case study to show the application and usefulness of the model. The results point not only to the alignment in that particular organization but also how this model can be applied in general to achieve better organizational alignment.

KEYWORDS: organizational alignment, organizational culture, leaders' values, strategy and structure, public sector

JEL CLASSIFICATION: D, D2, D23, M, M1, M14

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1. INTRODUCTION

Organizational alignment is seen as a way to enhance organizational effectiveness (Powell, 1992⁴; Tosti, 2007⁵; Biggs et.al., 2014⁶) and thus contributing to the successfulness of the organization (Andrews and Beynon, 2011⁷). It is a complex concept and there are various ways of looking at it and explaining it. However, despite the accentuated importance of the concept and its role in the success of organizations the efforts to actually measure the concept are rare. Very little empirical work has been dedicated to studying the relationship between culture and effectiveness (Dickson et al., 2000⁸; House et al., 2010⁹) and its relation with strategy (Baird, et al., 2007¹⁰). Another shortcoming of the research so far is that although a number of authors point to the need of adapting the measurements of culture to the broader cultural context (Choi, et al., 2010¹¹; Dastmalchian et al., 2000¹²; Hofstede et al., 1990¹³) research has been sparse in the South-East Europe. Therefore, the purpose of this paper is to

⁴ Powell, T.C. (1992). Organizational alignment as competitive advantage. *Strategic Management Journal*, Vol. 13, pp. 119-134.

⁵ Tosti, D.T. (2007) Aligning the culture and strategy for success, *Performance Improvement*, Vol. 46 (1), pp. 21-25.

⁶ Biggs, A., Brough, P. and Barbour, J.P. (2014) Strategic alignment with organizational priorities and work engagement: A multi-wave analysis, *Journal of Organizational Behavior*, Vol. 35, 301-317. DOI: 10.1002/job.1866.

⁷ Andrews, R. and Beynon, M.J. (2011). Organizational form and strategic alignment in a local authority: A preliminary exploration using fuzzy clustering, *Public Organization Review*, Vol. 11, pp. 201 – 218. DOI: 0.1007/s11115-010-0117-4.

⁸ Dickson, M.W., Aditya, R.N. and Chhokar, J.S (2000) Definition and interpretation in cross-cultural organizational culture research in N.M. Ashkanasy, C.P.M. Wilderom and M.F. Peterson (eds) *Handbook of organizational culture and climate*. Thousand Oaks: Sage Publications.

⁹ House, R.J., Quigley, N.R. and deLuque, M.S. (2010). Insight from project GLOBE: Extending global advertising research through a contemporary framework, *International Journal of Advertising*, Vol. 29(1), pp. 111-139.

¹⁰ Baird, K., Harrison, G. and Reeve, R. (2007) The culture of Australian organizations and its relations with strategy, *International Journal of Business Studies*, Vol. 15 (1), pp. 15-41.

¹¹ Choi, Y.S., Seo, M., Scott, D. and Martin, J. (2010). Validation of the Organizational Culture Assessment Instrument: An application of the Korean version, *Journal of Sport Management*, Vol. 24, pp. 169-189.

¹² Dastmalchian, A., Lee, S. and Ng, I. (2000) The interplay between organizational and national cultures: A comparison of organizational practices in Canada and South Korea using the Competing Values Framework, *International Journal of Human Resource Management*, Vol. 11 (2), pp. 388-412.

¹³ Hofstede, G., Neuijen, B., Ohayv, D.D. and Sanders, G. (1990) Measuring organizational cultures: A qualitative and quantitative study across twenty cases, *Administrative Science Quarterly*, Vol. 35, pp. 286-318.

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provide a way of measuring organizational alignment and show an example of such measurement in an institution operating in the public sector in the Republic of Macedonia. The paper will start by presenting the theoretical background and accentuate the new theoretical framework, Vox Organizationis – an instrument developed for looking at the level of alignment. It will then present the methodology of the study followed by the results of the applied methodology in one institution in the public sector in the Republic of Macedonia. The conclusion and recommendations for the future will be provided at the end of the paper.

2. DEFINING ORGANIZATIONAL CULTURE

Organizational alignment is a concept viewed from many different angles and encompassing different dimensions according to different authors. It draws on notions from industrial organization, strategy and organization theory (Powel, 1992¹⁴) as well as Human Resource Development (Alagaraja, 2013¹⁵; Semler, 1997¹⁶). However, most models of alignment put emphasis on some sort of “systematic agreement between forces within organization”¹⁷. The precursor of alignment was the congruence model which stated that the successful functioning of the organization depended on the level of consistency or fit between various components of the organizational system (Nadler and Tushman, 1989¹⁸). After that, many different viewpoints developed emphasizing different elements that can be part of the organizational alignment and different processes and connections between different elements.

¹⁴ Powell, T.C. (1992). Organizational alignment as competitive advantage. *Strategic Management Journal*, Vol. 13, pp. 119-134.

¹⁵ Alagaraja, M. (2013). Mobilizing organizational alignment through strategic human resource development, *Human Resource Development International*, Vol. 16 (1), pp. 74-93. DOI: 10.1080/13678868.2012.740794.

¹⁶ Semler, S.W. (1997). Systematic agreement: A theory of organizational alignment. *Human Resource Development Quarterly*, Vol. 8 (1), pp. 23-40.

¹⁷ Semler, S.W. (1997). Systematic agreement: A theory of organizational alignment. *Human Resource Development Quarterly*, Vol. 8 (1), p.16.

¹⁸ Nadler, D, A,, and Tushman, M, L, (1989). A model for diagnosing organizational behavior: Applying a congruence perspective. In D. A. Nadler, M. L. Tushman, C. O'Reilly (Eds,), *The management of organizations: Strategies, tactics, analyses* (pp, 91-106). New York: Harper & Row.

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For example, Semler (1997¹⁹) views organizational alignment as collaboration between the organizational design, strategy, and culture towards attaining the ultimate goal. Furthermore, the author notes that there are cultural aspects of alignment, performance aspects of alignment (ideal and actual behaviour) and environmental aspects of alignment. Labowitz (2004²⁰) reinforces this thinking by emphasizes that "alignment is an optimal state in which strategy, employees, customers, and processes work in concert" (p.30). On the other hand, Powell (1992²¹) stresses that alignment is a balance between organizational differentiation and integration. Along the same lines, Merron (1994²²) distinguished the following internal elements of alignment: purpose, strategy, objectives, structure, and culture, which should be working together and in the same direction. Zammuto, Gifford and Goodman (1999²³) defined four types of organizational culture which are defined by two axes having flexibility and control on one hand and the demands of the internal and external environment on the other.

Little previous research on organizational alignment has been done in the public sector. Some (Parker and Bradley, 2000²⁴) argue that there is a limited empirical understanding of the notion of culture in the public sector. According to their research, public agencies have a culture that focuses on rules and regulations and thus have little flexibility. However, their findings show that employees working for public organizations, although in general satisfied with their work, seek greater flexibility and have a more external focus than the one that is practiced in their organizations.

¹⁹ Semler, S.W. (1997). Systematic agreement: A theory of organizational alignment. *Human Resource Development Quarterly*, Vol. 8 (1), pp. 23-40.

²⁰ Labowitz, G.H. (2004) The power of alignment: How the right tools enhance organizational focus, *Business Performance Management*, pp. 30-34.

²¹ Powell, T.C. (1992). Organizational alignment as competitive advantage. *Strategic Management Journal*, Vol. 13, pp. 119-134.

²² Merron, K, A, (1994), Creating TQM organizations. *Qualify Progress*, Vol. 27 (1), pp. 51-54.

²³ Zammuto, R. F., Gifford, G. and Goodman, E. A. (1999). Managerial ideologies, organization culture and the outcomes of innovation: A competing values perspective. In N. Ashkanasy, C. Wilderom, & M. Peterson (Eds.), *The Handbook of Organizational Culture and Climate*. Thousand Oaks, CA: Sage.

²⁴ Parker, R., Bradley, L. (2000). Organisational culture in the public sector: evidence from six organisations. *International Journal of Public Sector Management*, Vol. 13 (2), pp.125 – 141.

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Holt (2014²⁵) gives examples of how public organizations in the United States have attempted to recognize employees' strengths and to assist them in enjoying work and reaching their true potential. He refers to matrix teams and matrix management which was introduced in NASA and facilitates horizontal flow of information between different departments. Employees with specific knowledge in an area find matrix teams invigorating since they provide them with addition knowledge of a related area. This goes in line with the notions of 'learning organizations' of Schein (2004²⁶) and Gaebler et al. (1999²⁷) which mean that organizations should be proactive in anticipating and initiating changes in their environment. Holt (2014²⁸) refers to 'fun' as a successful and inexpensive strategy that some local government agencies in the US implemented with great results. 'Fun' refers to having the time to do activities together with other employees, socialize and alike – small things that motivate employees and inspire employees to love their workplace.

Pulskamp and Benest (2003²⁹) in a report for Preparing the Next Generation explains that among other challenges that governments face are the anti-government biases, lack of succession planning and different values in general. He proposes that government and public organizations should be reorganized in order to emphasize on talent development, providing employees with the opportunity to learn both hard and soft skills as well to provide with employees with a broader view on the organization by moving around the organization and obtain a view on line and staff job aspects.

One comprehensive theory that is also very conducive towards testing of organizational alignment has been proposed by Tosti (2007³⁰). The model highlights

²⁵ Holt, T. (2014). Creating a Great Organizational Culture in the Public Sector. Retrieved April 11, 2015, from <http://patimes.org/creating-great-organizational-culture-public-sector/>

²⁶ Schein, E.H. (2004). Organizational culture and leadership. San Francisco: Jossey Bass.

²⁷ Gaebler, T., Blackman, J., Blessing, L., Bruce, R., Keene, W., and Smith, P. (1999). Positive Outcomes: Raising the Bar on Government Reinvention, 1st ed., Chatelaine Press.

²⁸ Holt, T. (2014). Creating a Great Organizational Culture in the Public Sector. Retrieved April 11, 2015, from <http://patimes.org/creating-great-organizational-culture-public-sector/>

²⁹ Pulskamp, T., Benest, K. (2003). Local governments preparing for the next generation: successful case studies. Cal-ICMA California Consortium.

³⁰ Tosti, D.T. (2007) Aligning the culture and strategy for success, Performance Improvement, 46 (1), pp. 21-25.

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that the results than organizations achieve depend not only on the processes followed in the organization but also on the practices that people demonstrate within the organization. This means that the way people behave will make a difference between good results and outstanding results even in well-designed processes. Therefore, both alignment in the processes as the formal side of organizational functioning, and the practices as the non-formal side of the organizational functioning, are equally important. Those two aspects provide the overall alignment of the organization. The complete alignment model contains the goal processes and tasks on one side and the values, practices and behaviours on the other side (see Figure 1). What this means is that the structure and organizational design as seen by Semler (1997³¹) including the policies of the organization can be viewed as the formal side of the operational functioning when looking at organizational alignment. On the other hand, the organizational culture and leadership values as accentuated by Semler (1997³²) can be viewed as the non-formal side of the organizational functioning.



Figure 1 – Organizational alignment model (Tosti, 2007³³)

³¹ Semler, S.W. (1997). Systematic agreement: A theory of organizational alignment. *Human Resource Development Quarterly*, Vol. 8 (1), pp. 23-40.

³² Semler, S.W. (1997). Systematic agreement: A theory of organizational alignment. *Human Resource Development Quarterly*, Vol. 8 (1), pp. 23-40.

³³ Tosti, D.T. (2007) Aligning the culture and strategy for success, *Performance Improvement*, 46 (1), pp. 21-25.

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A number of researchers have decided to develop their own idiosyncratic way for assessing organizational culture in the specific context of their project (Ashkanasy et al, 2010³⁴). The present paper proposes a model for measuring the organizational alignment building on the thinking of both Semler (1997³⁵) and Tosti (2007³⁶). Therefore this paper uses a model of alignment looking at the organizational culture and leadership values on one side as non-formal part of the organizational functioning, and on the other side, the organizational structure, strategy and policies as the formal side of the organizational functioning. (see Figure 2.) (Tomovska-Misoska et al., 2011³⁷). Each of the elements will be briefly explained in addition.

- Organizational culture is a much debated part of the organizational functioning. A number of authors have tried to provide definitions underlying components such as values, beliefs, practices and principles that are shared or common among members of one organization (Jaivisarn, 2010³⁸; Singh, 2007³⁹). Schein (2004⁴⁰) and Hofstede (1998⁴¹) propose models of organizational culture which emphasize different levels of representation and analysis of organizational culture. Hofstede (1998⁴²) views culture as an onion that has organizational practices as a visible representation of the second deeper level consisted of heroes, symbols and rituals, whilst the third invisible layer are

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³⁵ Semler, S.W. (1997). Systematic agreement: A theory of organizational alignment. *Human Resource Development Quarterly*, Vol. 8 (1), pp. 23-40.

³⁶ Tosti, D.T. (2007) Aligning the culture and strategy for success, *Performance Improvement*, 46 (1), pp. 21-25.

³⁷ Tomovska-Misoska, A., Bojadjiev, M., Stefanovska, M. and Nikolovska, Z. (2011). Vox organizationis – theoretical basis and methodological considerations in the development of an instrument for organizational culture. Munich Personal RePec Archive Working Paper. Retrieved March 29, 2015, from <http://mpra.ub.uni-muenchen.de/42571/>.

³⁸ Jaivisarn, V. (2010) How organizational culture of Japanese multinationals in Thailand influences Japanese-speaking Thai employees' organizational commitment, *Journal of International Business and Economics*, 10 (1), pp. 106-120.

³⁹ Singh, K. (2007). Predicting organizational commitment through organization culture: A study of automobile industry in India. *Journal of Business Economics and Management*, Vol. 8 (1), pp. 29-37.

⁴⁰ Schein, E.H. (2004). *Organizational culture and leadership*. San Francisco: Jossey Bass.

⁴¹ Hofstede (1998). Attitudes, values and organizational culture: Disentangling the concepts. *Organization Studies*, Vol. 19 (3), pp. 477-492.

⁴² Hofstede (1998). Attitudes, values and organizational culture: Disentangling the concepts. *Organization Studies*, Vol. 19 (3), pp. 477-492.

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the values. This is similar to Schein's (2004⁴³) thinking that puts artefacts as visible representations, values and beliefs as day to day operating principles, and underlying assumptions as the deepest level that actually guides behavior. Their research goes in line with later research done with regards to the relation between organizational culture and individual outcomes (Jaivisarn, 2010⁴⁴; Nazir, 2005⁴⁵; Singh, 2007⁴⁶; Su, et al., 2009⁴⁷). The culture is usually measured by asking the members of the organization about the current behaviors and practices (Hofstede, 1998⁴⁸). According to Jex and Britt (2008⁴⁹), the most direct way to measure organizational culture is to create a type of a self-reported measure that would be administered among employees of the sample organization and afterwards create a numerical index that would be used to assess and describe the different types of organizational culture.

- Leader's values are the second part of the model. They are quite important as the leaders set directions for and can intentionally influence the organizational culture. The values set the preferences and judgements about desirable and undesirable alternatives (Semler, 1997⁵⁰). The leaders also influence the values and beliefs of the organizational members (Schein, 2004⁵¹). In addition, the perception that the employees have on the behaviour of the leader and the shared leadership influences

⁴³ Schein, E.H. (2004). *Organizational culture and leadership*. San Francisco: Jossey Bass.

⁴⁴ Jaivisarn, V. (2010). How organizational culture of Japanese multinationals in Thailand influences Japanese-speaking Thai employees' organizational commitment, *Journal of International Business and Economics*, 10 (1), pp. 106-120.

⁴⁵ Nazir, A.N. (2005). Person-culture fit and employee commitment in banks, *Journal for Decision Makers*, 30 (3), pp. 39-51.

⁴⁶ Singh, K. (2007). Predicting organizational commitment through organization culture: A study of automobile industry in India. *Journal of Business Economics and Management*, Vol. 8 (1), pp. 29-37.

⁴⁷ Su, S., Baird, K. and Blair, B. (2009) Employee organizational commitment: the influence of cultural and organizational factors in the Australian manufacturing industry, *The International Journal of Human Resource Management*, 20 (2), pp. 2494-2516.

⁴⁸ Hofstede (1998). Attitudes, values and organizational culture: Disentangling the concepts. *Organization Studies*, Vol. 19 (3), pp. 477-492.

⁴⁹ Jex, S.M. and Britt, T.W. (2008). *Organizational psychology: A scientist-practitioner approach* (2nd edition). Hoboken: John Wiley and Sons.

⁵⁰ Semler, S.W. (1997). Systematic agreement: A theory of organizational alignment. *Human Resource Development Quarterly*, Vol. 8 (1), pp. 23-40.

⁵¹ Schein, E.H. (2004). *Organizational culture and leadership*. San Francisco: Jossey Bass.

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the organizational citizenship behaviour – OCB (Khasawneh, 2011⁵²; Greene-Shortridge, 2011⁵³).

The measurement of the values is done through asking the leaders about desirable or ideal situation in the organization as suggested in the GLOBE approach (Dickson, et al, 2000⁵⁴; House et al, 2010⁵⁵).

Organizational structure, strategy and policies represent the formal aspect of the organizational functioning. As such they define the goal-directed behavior (Semler, 1997⁵⁶). They set up the goals and objectives of the organization, and set up the processes and tasks of the employees (Tosti, 2007⁵⁷).

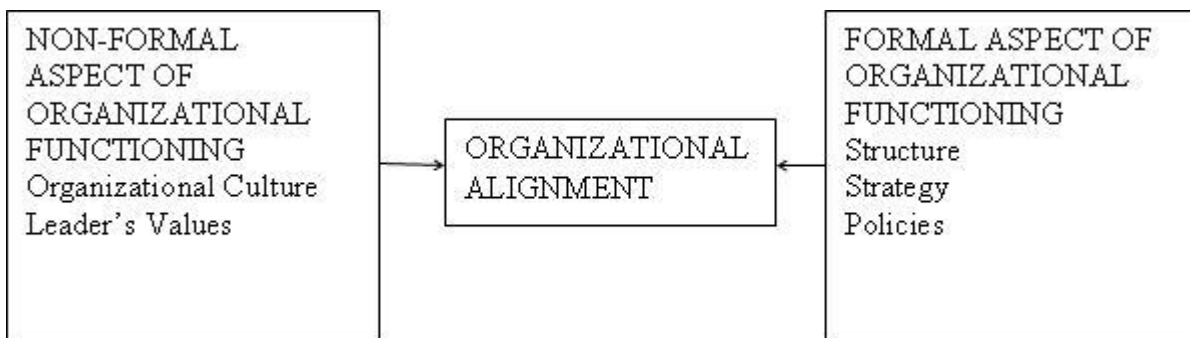


Figure 2 – Vox Organizationis Organizational Alignment Model

These four elements of the model are measured on four dimensions connected to the organizational functioning developed through synthesis of dimensions previously

⁵² Khasawneh, S. (2011). Shared leadership and organizational citizenship behaviour in Jordanian public universities: Developing a global workforce for the 21st Century. *Educational Management Administration Leadership*, Vol. 39(5), pp. 621-634.

⁵³ Greene-Shortridge, M. T. (2011). Leadership, employee wellbeing and organizational citizenship behaviors. Available online at <http://business.salary.com/leadership-employee-well-being-and-organizational-citizenship-behaviors>

⁵⁴ Dickson, M.W., Aditya, R.N. and Chhokar, J.S (2000). Definition and interpretation in cross-cultural organizational culture research. In N.M. Ashkanasy, C.P.M. Wilderom and M.F. Peterson (Eds.) *Handbook of organizational culture and climate*. Thousand Oaks: Sage.

⁵⁵ House, R.J., Quigley, N.R. & DeLuque, M.S. (2010). Insight from project GLOBE: Extending global advertising research through a contemporary framework, *International Journal of Advertising*, Vol. 29(1), pp. 111-139.

⁵⁶ Semler, S.W. (1997). Systematic agreement: A theory of organizational alignment. *Human Resource Development Quarterly*, Vol. 8 (1), pp. 23-40.

⁵⁷ Tosti, D.T. (2007) Aligning the culture and strategy for success, *Performance Improvement*, 46 (1), pp. 21-25.

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used by other authors and adapting them to be used in context to South Eastern Europe. The dimensions are bipolar (Tomovska-Misoska et.al. 2011⁵⁸):

- Decision making and behaviour – connected to the democratic or bureaucratic approach to decision making. On one end it has strict policies and procedures and on the other shared culture and common understanding between members;
- People versus task – it accentuates care for the tasks on one end and care for the people and personal relationships on the other;
- Innovativeness and risk taking – this dimension measures instigating of innovations and risk taking by the company and its employees;
- Open versus closed system – connected to the collaboration between the members of the organization as well as the cooperation between the organization and its environment.

3. METHODOLOGY

The study was performed in an institution operating in the public sector in the Republic of Macedonia in February 2014. The data collection lasted for one month using questionnaires specifically designed to measure the Vox Organizationis model (Tomovska et.al., 2011⁵⁹).

There were three different instruments used, two of them measured the non-formal part of the organizational functioning and one measured the formal part. The employees received printed questionnaires containing 35 questions related to the four dimensions of the model for measuring the organizational culture (what are the practices and behaviours valued in the organization) and six questions with demographic data. The leaders received a questionnaire containing 35 questions

⁵⁸ Tomovska-Misoska, A., Bojadjiev, M., Stefanovska, M. and Nikolovska, Z. (2011). Vox organizationis – theoretical basis and methodological considerations in the development of an instrument for organizational culture. Munich Personal RePec Archive Working Paper. Retrieved March 29, 2015, from <http://mpra.ub.uni-muenchen.de/42571/>.

⁵⁹ Tomovska-Misoska, A., Bojadjiev, M., Stefanovska, M. and Nikolovska, Z. (2011). Vox organizationis – theoretical basis and methodological considerations in the development of an instrument for organizational culture. Munich Personal RePec Archive Working Paper. Retrieved March 29, 2015, from <http://mpra.ub.uni-muenchen.de/42571/>.

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related to the four dimensions which were equal to those of the employees but measured the leaders' values (how would an ideal organization look like). These two instruments measured the non-formal part where: questions 1 to 9 measured the dimension decision making and behavior so a high score on this dimension points to a more democratic approach; questions 10 to 17 referred to people versus task and high scores outlined care for people; questions 18 to 24 measured the dimension innovativeness and risk taking and a high score indicates encouraging of risk taking and innovativeness; and questions 25 to 35 measured open versus closed system where high scores indicated a more open and transparent organization. All four dimension were measured using a four point Likert scale and some of the questions were reverse coded to prevent response set.

To assess the formal aspects of the organizational functioning interviews with the leaders using the third instrument were performed. The interview protocol contained questions about the structure, the strategy and the policies of the organization. The questions were again grouped into the four dimensions. Seventeen questions were designed for the dimension „decision making and behavior“, eight questions referred to „people versus task“, three questions were dedicated to „innovativeness and risk-taking“ and ten questions referred to the dimension „open versus closed system“. The results were then assessed to see whether the formal aspect leans towards one or the other pole of each dimension.

After the responses for each type of instrument were collected and the scores for each dimension were obtained, they were then compared to check for the overall level of alignment. This approach also allows us to see whether there is particular problem in a certain area, since each question set points to a specific area of organizational functioning.

The response rate for the employees was 75%, and in total 30 useable responses were collected. In addition, the two leaders of the institution took part as well. Of the total number of employees 60% were male and 40% were female. Half of the employees have been employed in the institution between 5 to 10 years and

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another 25% were in the institution between 1 and 5 years. Most of the employees had bachelor degrees (70%) followed by Masters/PhD (22%) and secondary education (7%). When it comes to the leaders they were both male with bachelor degrees. They were both working in that position between 1 and 5 years, but have been working in the same sector for more than 10 years.

4. RESULTS

Based on the employee answers the scores for each dimension of the organizational culture instrument were calculated first. The results are presented in Figure 3.

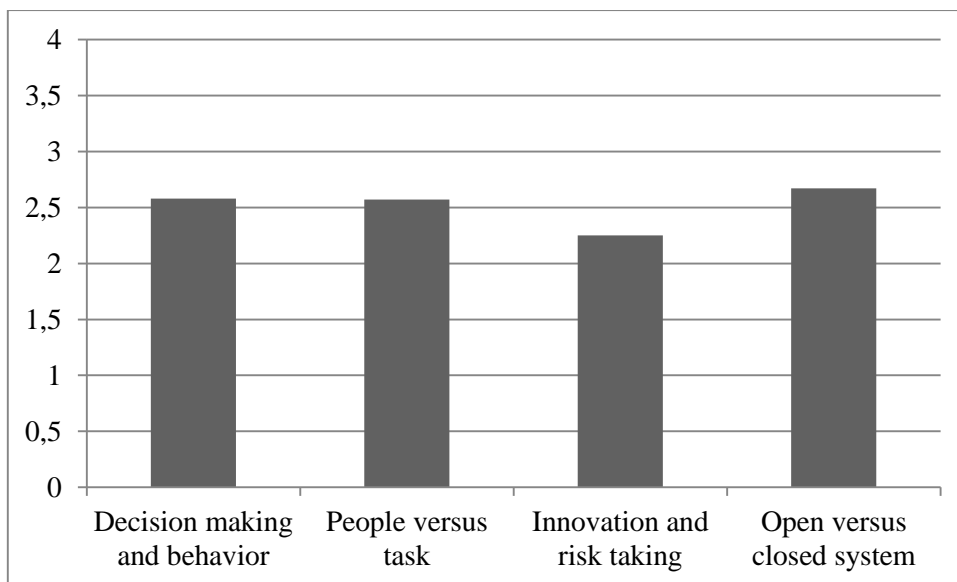


Figure 3 – Organizational culture results

As it can be seen from Figure 3 the results for the 'decision making & behavior' dimension (2.63 out of 4.00) indicate that the employees view the organization as leaning towards a democratic rather than bureaucratic way of decision making. This means that the employees feel that the organization involves them in decision making and there is shared understanding for "acceptable" organizational behavior without the need for strict policies and procedures. For the 'people versus task', the results (2.53 out of 4.00) indicate that the employees view the organization as caring slightly more for the well-being of their people as opposed to the accomplishments of tasks. This suggests that the organization, in the employees' eyes is somewhere between the

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spectrum of work oriented and people oriented. When it comes to 'innovation and risk taking' employees (2.42 out of 4.00) view the organization as moderately innovative and risk taking. The scores for the fourth dimension indicate that the employees view the organization as more open than closed (2.56 out of 4). This means that the employees appraise that the organization supports both intra-sectoral and inter-sectoral collaboration as well as collaboration with people and organizations from the broader environment.

The scores of the leaders' values instrument were calculated next. They were then compared with the scores of the organizational culture instrument to assess the general alignment of the non-formal aspect of the organizational functioning. The results point to the alignment of how the leaders envisage the „ideal organization“ and work towards establishing such values in the organization and what is the actual behaviour and practices present in the organization as experienced and expressed by the employees. Table 1 and Figure 4 present side by side comparison of the scores on each of the four dimensions on the organizational culture and the leaders' values.

Table 1 – Comparison of the organizational culture and leaders' values scores on the four dimensions

	Decision making and behavior	People versus task	Innovation and risk taking	Open versus closed system
Leaders' values	3	3.06	2.57	3.2
Organizational culture	2.58	2.57	2.25	2.67

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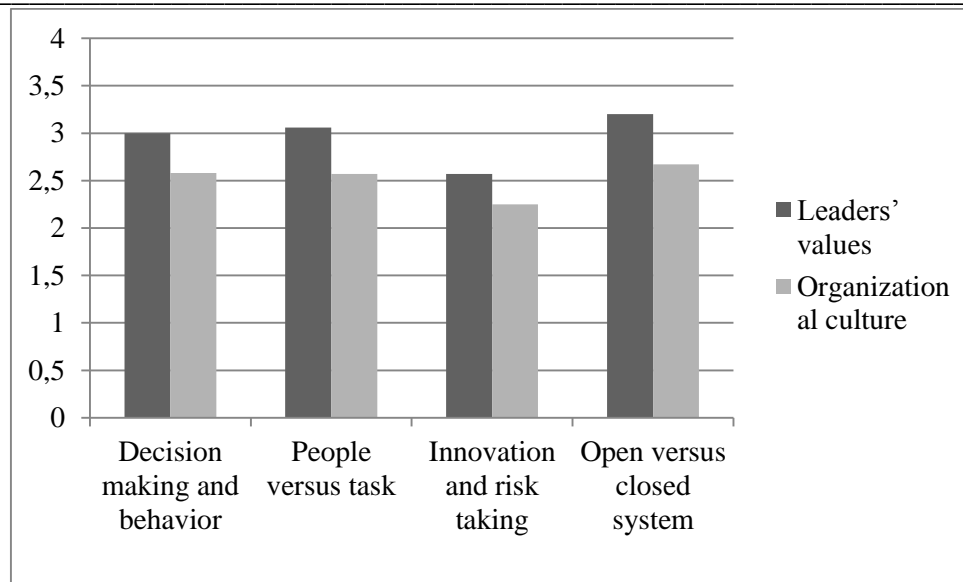


Figure 4 - Comparison of Leaders' Values and Organizational Culture results

As can be seen in Figure 4, leaders have slightly higher appraisal of the dimensions „decision making and behaviour“, „people versus task“ and „open versus closed system“, whilst they have lower values than the employees on the dimension „innovation and risk taking“. This means that the leaders would like to see the organization as striving more towards stability and not so much risk taking and employees feel that the organization is slightly more risk taking at the present time. However there is general agreement between the employees and the leaders when it comes to the non-formal aspect of the organizational functioning. This means that the non-formal aspect of the organizational functioning shows good alignment except for the „innovation and risk taking“ where the alignment needs to be improved.

The formal aspect of the organizational functioning was calculated last. The results were then compared to the results of the non-formal aspect to appraise the overall organizational alignment. Table 2 shows side by side comparison for the overall appraisal of each dimension as gathered by the three different instruments.

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Table 2 – Comparison of the formal and non-formal aspect of the organizational functioning on the four dimensions

	Decision making and behavior	People versus task	Innovation and risk taking	Open versus closed system
Leaders' values	Democratic	People oriented	Innovative	Open
Organizational culture	Democratic	People oriented	Indecisive	Open
Formal aspect	Bureaucratic	People oriented	Innovative	Open

As can be seen, the organizational alignment is quite good in the public sector institution used in this study. There is one dimension that needs slightly more attention and that is the dimension „innovativeness and risk taking“. Whilst the organizational culture encourages taking risks and innovating as seen by the employees' answers, the leader's values point to indecisiveness when it comes to this dimension. The results of the analysis of the formal aspects also point to balance between maintaining stability and promoting risk taking. This means that the leaders need to pay more attention to building a culture that will be aligned with the other aspects of the organizational functioning on this dimension. What is more important however, is that on certain questions regarding the formal functioning of the organization the two leaders had slightly different opinions which might pose bigger issues and problems. For example they had different views on how the strategic plan is drafted. This might be due to how they got the position: one was promoted to the position and the other one politically appointed. Regardless of this, more attention should be paid to aligning their views and positions before turning to the employees.

5. CONCLUSION

This paper focused on a very important aspect of the organizational functioning and that is organizational alignment. The concept is much debated and although there are many different theoretical models, the concept is still under-researched especially in South Eastern Europe. Therefore this paper is of special importance as it proposes a model for measuring the organizational alignment, as well as illustration of how the model works in practice through a case study of one public sector institution in the Republic of Macedonia. The results point to a high degree of alignment within the institution and outlines areas of improvement. The instruments can be useful for looking at specific areas within the organization that are misaligned and provide guidelines as to how alignment can be improved. Each dimension can be viewed more in depth by looking at particular answers in all three instruments to gain ideas for future actions leading towards alignment. It can also serve as a viewpoint and in consultation with the leader; a decision can be made whether the formal or the non-formal aspect should be the area of intervention to achieve alignment.

Although the results of the study are quite useful and show the applicative value of the model the results are still based on one case study example. In the future more studies using the same approach should be done to test the validity of the model. The model should also be tested in different sectors and different countries to show the applicative and theoretical value.

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UDC: 339.138:336.71]:303.62(497.7)

BTL ACTIVITY AS A TOOL IN SALES STRATEGY AND SUSTAINABILITY OF COMPETITION IN THE BANKING SECTOR

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ABSTRACT

The application of marketing in banking enables integration of certain banking operations and comprehensive solution for customers, i.e. use of promotional techniques as a part of an ongoing promotion of the standard package of banking products and services. The focus of this study should answer the question how often BTL promotion activities are used as non-media communication of banks and banking institutions with their customers. Experts believe that the success of BTL technique starts with a good database for customers (clients) where comprehensive data for the individual current and potential customers are collected, including details of their geographic, demographic and psychographic behavior when buying.

The purpose of this research paper is to show how important are BTL activities in sales strategy, if they are applied in the banking sector for more effective reach to the targeted customers and building stronger, closer and long-term relationships. Therefore, here the advantages and disadvantages of the use of BTL techniques as a means of communication with the banks in the country will be outlined. Following research techniques have been used: canvassing technique, interview and attitudes assessment technique. For elaboration, as a general scientific method, statistical method has been applied, as well as method of analysis and synthesis, and method of inductive and deductive reasoning as a specific scientific method. The results are to serve as an additional challenge for further activities focused on study and development of BTL marketing techniques by companies in the Republic of Macedonia.

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KEYWORDS: integrated marketing communications, marketing in banking, promotional techniques, BTL tool, one-to-one marketing

JEL CLASSIFICATION: M31

1. INTRODUCTION

Integrated marketing communication approach to consumers, increases efficiency and improves approaching to consumers, establishing combined approach to several media at the same time. It imposes a need for classification of the ways in which companies could be promoted in public. Promotional techniques can be ATL and BTL and recently mentioned TTL activities. The division is made because of differences that occur in the individual marketing activities, which often come to the following: differences in the financing needs, differences in human resources and expertise, necessary time from planning to implementation, communication with externals or institutions etc. In fact, ATL, BTL and TTL represent acronyms of Above the Line, Below the Line and Through the Line, promotional strategies for penetration to the consumer. Almost there is hardly any marketing plan or budget of modern companies that lack such a division of the activities.

Therefore, throughout this paper there is a view that banks develop a systematic approach to policy promotion, as an effective tool which is built on customer requirements. Effective promotional strategies emphasize the competitive advantages of each bank, each new product offered for sale, in order to become closer and clearer to customers, i.e. easy comparable, more convenient and more diverse than those offered by the competition.

BTL, ATL and TTL tools as promotional techniques in the sales strategy

The ways in which companies could be promoted to the public impose the division of the promotional techniques of ATL and BTL activities and recently mentioned TTL activities. ATL includes most remarkable techniques (TV, Radio, OOH (out of home) billboard campaigns, print media etc.). On the other side, BTL includes promotional strategies, which are determined as non-media communication (posters, pamphlets, organizing events, Road show techniques, prices reduction, public relations etc.). TTL

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promotion techniques represent a mix between these two strategies. These strategies are oriented to a final strategy that combines ATL and BTL communication, where one form of promotion is directed toward the target of the other forms of promotion. Unlike mass marketing targeted to the general public and use of standardized messages and offers, today modern trend is directing messages and offers to narrow, targeted market or application of the "one-to-one"⁴ marketing, which is a combination of BTL activities. This goal should be achieved through BTL strategy for more effective penetration to target customers and building stronger, closer and long-term relationships. For the realization of BTL promotional techniques, banks use databases to adjust their marketing offers and communications needs of narrowly defined segments and individual customers. These databases should contain lots of information for: products and services, pricing, target, status of current contracts, estimated costs per client for the next few years and assess the competitive strengths and weaknesses in sales, serving consumers and so on.

The advantages of BTL marketing application are numerous, although it is a short-term promotional marketing technique: interactivity, targeting a well-defined target market composed of real and potential clients, one-on-one marketing⁵, implying a quick response from clients, measurable results, an opportunity to develop long-term relationships with clients based on current and well-developed databases. BTL way of running promotional sales activities have economic viability, according to calculations in a marketing plan that shows 50% less funding needed for providing telephone info line, setting up an info panel for customers, making the promotion of social media etc., compared to use of mass communication media. Certainly, this is not an indicator of performance versus other ways of promotion. On the contrary, unconventional, more direct ways to access customers provide fast results in marketing⁶. Bank can

⁴ Competitive advantage in banking aims to reduce costs through customer retention and increase revenue through customer loyalty, which is the aim of the one-to-one marketing as searching for opportunities to communicate with each individual customer (approach with a rifle)

⁵ Charles W. Lamb, M.J Neeley School of Business Texas Christian University; Joseph F. Hair, JR. Department of Marketing, Kennesaw State University; Carl McDaniel Department of Marketing University of Texas at Arlington; *Marketing 11*, 2009 South Western Cengage Learning

⁶ Christopher Lovelock, Jochen Wirtz, Services Marketing – People, Technology, Strategy, 7th ed., Upper

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immediately, at the relevant time, obtain feedback from potential customers, but at the same time to see the view of certain shortcomings in the bank, in terms of providing products and services to competition.

Empirical Research

Despite positive effects of BTL techniques, there has been detected a problem of less intensive use of BTL activities in the banking sector of the Republic of Macedonia. Therefore, a subject of research in this paper is to present the possibility of intensive use of appropriate marketing tools (BTL activities in sales strategy) in the banking sector. The process of empirical research is through use of questionnaire with a check list (implementation of a written survey in the form of a questionnaire) and a selection of features (gender, educational background) by calculating the average grade, due to benefits that are achieved: efficiency, anonymity of respondents, large sample, easier and more efficient statistical analysis of results compared to other methods. To measure the research phenomenon, i.e. the influence of BTL tools as an activity in sales strategy, 197 customers were surveyed in several banks in the Republic of Macedonia. Sample size was determined through a simple procedure, random choice by applying the adjustments factor to a specific activity. The poll was conducted in the period March-May 2012.

The questionnaire is structured into three groups:

- **General questions**, where respondents' gender and age was analyzed.
- **Order of important categories** where respondents individually, by importance, assessed given solutions.
- **Evaluation of statements**, where respondents individually evaluated given factors or activities.

Hypothetical framework

Conducted empirical research⁷ provides insight on the following general hypothesis: **If** BTL activity is used in the sales strategy of a particular product or

Saddle River, New Jersey, Prentice Hall, 2011, p. 38

⁷ MA Makenadzhieva, I.,: BTL activity as a tool in sales strategy, research master's thesis (2013)

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service, **then** marketing strategy effectiveness will show an increase. Proving the hypothesis is implemented through several set specific and individual hypotheses^{8,9}.

Particular hypothesis 1

If promotion is highlighted marketing tool, then the effectiveness of marketing strategy will show an increase. As *Individual hypothesis 1.1 in proof is*: if the promotion of sales (as a main goal of BTL activity) includes: promotion of consumers, of trade, of business and sales force, then BTL tool will stimulate faster or greater sales of certain products or services. (Questions no. 1, 3, 4, 10, 11, 17, 19).

Particular hypothesis 2

If BTL activities are used for short and specific period of time, then the effectiveness of marketing strategy will show an increase. As *Individual hypothesis 2.1*. The **proof is**: if the BTL tool for encouraging sales is designed with short period of time effects, then it will contribute to greater and faster sale of certain products/services. (Questions no. 5, 6, 13, 14, 18, 20).

Particular hypothesis 3

If with BTL activities are applied unconventional channels of advertising, the effectiveness of marketing strategy will show an increase. As *Individual hypothesis 3.1*. The **proof is**: If in BTL activity are used unconventional channels of marketing communication, then BTL activity is a significant supporter of the sale of corresponding products and services. (Questions no. 2, 7, 8, 9, 12, 15, 16).

RESULTS AND DISCUSSION

Demographic data of the questionnaire (the first group) have surveyed clients of both genders, 52% women and 48% men and according to the age classification, participants are with the following structure: From 25-29 years 22%; from 30-34 22%; from 35-44 years 25%; from 45-54 years 17% and 55-64 14%.

⁸ Dragovic, Dr. A. Borota Popovska M., (2010): Methodology of Social Research, University "St. Cyril and Methodius", Institute for Sociological, Political and Juridical Researches, Skopje Practice for internal use

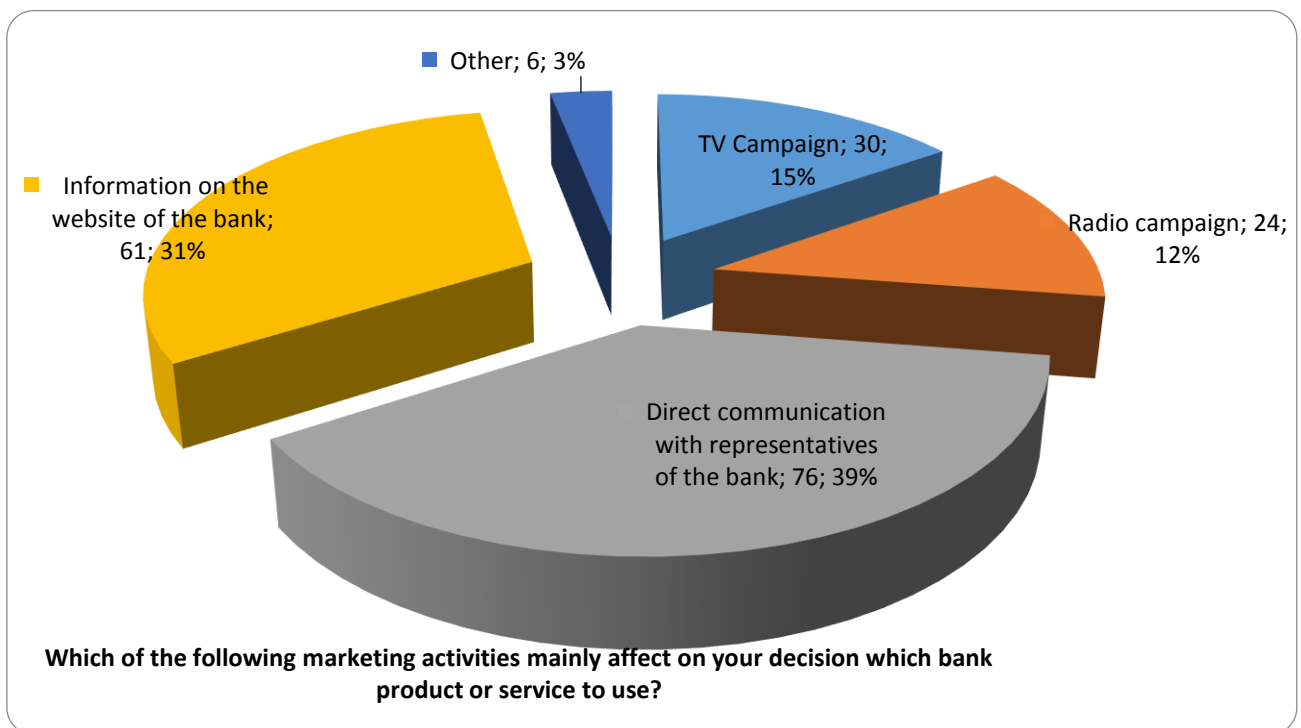
⁹ Zelenika, R. (2000): Methodology and technology of scientific and professional papers, IV ed. Rijeka Faculty of Economics

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The second and third part of the questionnaire represents the customers' views about the impact of promotional activities on their decision to use a particular bank service. The total number of questions points that give answer to one variable are collected and then divided by the number of questions. To understand clearly the idea of grading, the result from the average score for each variable will be divided by the number of respondents so we can obtain arithmetic average of variable that can range from minimum 1 to maximum 5. The arithmetic average if is bigger than 2.5 confirms variable, while the arithmetic average less than 2.5 rejects.

The survey performs individual analysis and opinions, specificity of promoting banking products and services to its customers. Most of respondents chosen non-media techniques of communication, before making a decision to use a particular service from banks.

Graph 1. Impact of marketing activities on customer choice



To the question how quickly you spot the direct promotional presentations of banks? The results show that the greatest effect of recording the presentations is

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received in circumstances where these are intensified in the short term. 59% of respondents have found that, while 20% of respondents, because of the intensity of promotions, quickly notice the new offer of banking products and services. Related to the previous question, whether frequent meetings with bank promoters affect you to know in detail their products or services?, 77% of respondents said that frequent meetings with the promoters absolutely affect on their decision when choosing a product or service of the bank, while only 3% said that they do not pay any attention of staff when they are interested in particular product or service. According to the results, 73% of respondents prefer to receive special attention of the bank when they are interested in a particular product or service, which impose the importance of rapid response communication with customers. The average score of the listed questions ranges from 3.50 to 4.20.

The survey has investigated opinion about promotion of bank products and services. Most of respondents believe that the most appropriate way to obtain more detailed information would be direct post and promotional stands of certain organized events on frequency locations. The respondents believe that this promotion mix would cause a positive effect. The opinion of the respondents to obtain information through e-mails or direct mail is with a ratio of 1: 1, for receiving promotional offers as a good practice.

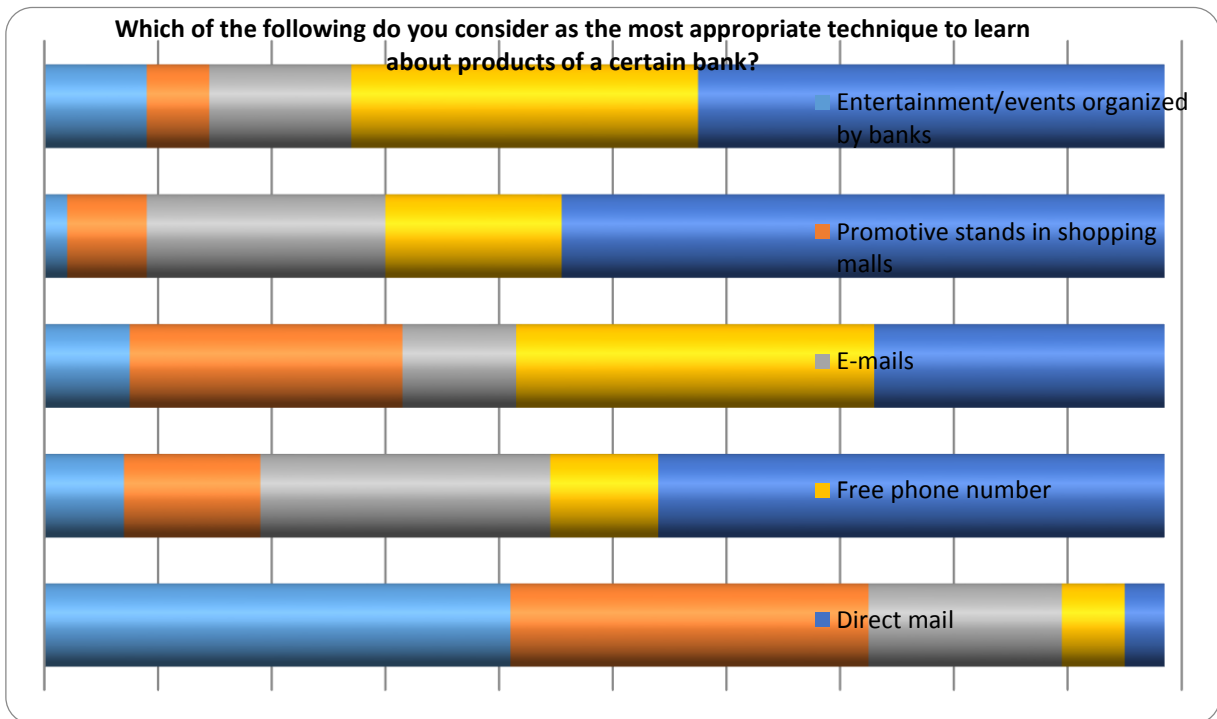
This research has recorded greater awareness of customer for Internet techniques as a way of promoting banks. Regarding this issue, the following results show 55% of respondents who have noticed the promotion of a bank online. Low 3% of respondents did not notice that way of promotion even though they know about it, and 4% of the customers did not notice the promotion of banks in the Republic of Macedonia on the Internet. The remaining respondents alternatively review all ways of promotion of banking products and services. In this respect the average rating is 3.40.

Due to the significance of social media and their greater expansiveness in the business world, the research is directed towards the opinion of respondents about promotion of banks using these channels. Significant 64% of respondents see it as a

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great promotion of the banks through social media, while 28% of them think that this is a positive way of promotion, but not sufficient. The analysis perceives customers' attitude in terms of their habit and positive attitude towards presence of specific promotions organized by banks on places where they usually buy. 54% of respondents said they would like to attend the presentation of a bank where they could receive information about specific benefits offered by the bank through its products or services, 42% wish to attend the promotions only for certain services, while 4% would not like any presentation by banks where they buy. The graph below presents average grades given by respondents for promotional techniques and their impact on bank product or service presentation. Because this paper analyzes BTL marketing techniques, there are some unconventional techniques of promotion. According the results, the highest average grade of 4.12 was for a direct mail, as a way of communication with customers about the products and services offered by the bank. The lowest score of 1.97 was for entertainment and other similar events organized by banks.

Graph 2. Promotional techniques for introducing banking products



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Regarding specific promotional techniques and their impact on customers, 38% of respondents said that the promotional activities of the bank play very important role in decision making to use a particular service from the bank. 28% of respondents in turn, think that promoting action and offer of the most favorable interest rates would affect on their decision. The lowest percentage is of those respondents who think that offered product brand would influence the decision and to use it.

In this regard, from the graph 2 can be noticed that using properly implemented promotional techniques can boost services and products sales offered by banks. This conclusion is confirmed by the following graph 1 which notes that most of the respondents or 70% responded that the unconventional ways of promotion (direct communication and Web sites of banks) are techniques that have the greatest influence on their decision to use certain offer from the banks. *Hence (hypothesis 1) BTL tool can stimulate faster or higher sales of certain products or services.*

In the survey, respondents had the opportunity to evaluate individual banks in terms of their marketing communication. It can be noted that the two best average grades are the longest present banks in this market: Commercial Bank with average grade of 4.15 and Stopanska Bank with an average grade of 3.91. Interesting fact for the third one, i.e. Sparkasse Bank, with an average grade of 3.76. The lowest evaluation for marketing communication has ProCredit Bank with an average grade of 3.31.

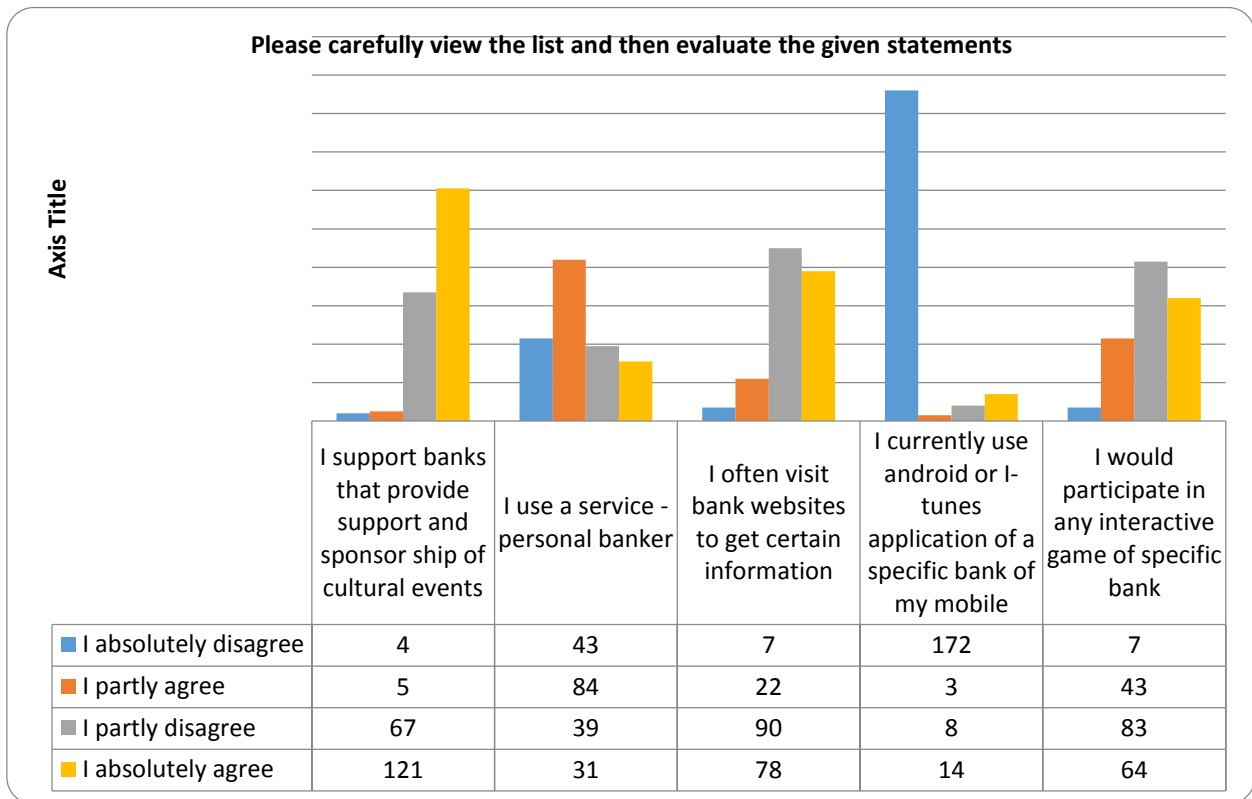
Regarding the importance of using unconventional channels of communication with consumers, is actually the assessment of banks in Republic of Macedonia. Practice in both, longest established banks in Macedonia, Komercijalna Banka and Stopanska Bank, speaks about the importance of long-term and permanent communication with customers, not only through the media but also through applying the activities that prove the social responsibility of banks, organizing competitions for customers, direct and frequent contact of places where there are potential customers and other BTL marketing activities. *Based on the analyzed data, the general hypothesis: If in the sales strategy of a particular product or service are used BTL activities, the effectiveness of marketing strategy will increase, is fully proven.*

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The next question of the survey is directly focused to specific promotional activities of banks and respondents’ opinion about them. Regarding this issue, as best assessed promotion are promotional stands of the banks, while the weakest average grade is representative gifts as a way of promoting banks, with an average grade of 2.27.

The survey is summarized by evaluating statements by respondents, where the highest proportion of them absolutely support the banks, highlighted as socially responsible companies in different spheres of civil society. The average score is 4.45.

Graph 3. Social responsibility of the banking sector



As an excellent practice of banks, 68% of respondents rated organizing presentations by banks for certain products and services, as a technique which has quick and effective action. Again the need for rapid and effective action is confirmed by the results, where most respondent’s rate free line info as the most appropriate way

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of obtaining certain information on individual products and services to banks. The average rating ranged from 3.50 to 4.44.

Hence, (hypothesis 2), if BTL activities are used for short and specific period of time, then the effectiveness of marketing strategy will increase, is actually BTL tool designed with effects for a short period of time, then it will contribute to greater and faster sale of specific products/ services.

The results also confirm the *hypothesis 3, if BTL activities apply unconventional channels of advertising, the effectiveness of marketing strategy will increase or in BTL activities should be used unconventional channels of marketing communication (direct mail, telemarketing, interactive marketing, promotions positions and the consumer) then BTL activity is a prominent supporter of the sale of the products and services.*

CONCLUSION

Promotional activities expressed by BTL techniques actually have the objective of direct communication with customers. Banks that are subject of research in this paper are more frequent users of these marketing techniques. Research shows that customers in particular banks with great interest follow the messages of banks. Because of greater offer, they often based their choice on the basis of direct communication with banks.

Therefore, BTL marketing techniques have to present more common solution for banks to access their customers. The skill and the actual effects of BTL techniques are proper identification (those that are most appropriate to the market) and their successful implementation in the market to customers.

Conducted research in this paper emphasizes the positive image of the customer for such unconventional BTL techniques as a means of communication with the banks in the country. There is a growing trend of customers who are informed about the new ways of promotion by banks that use online techniques. Also, there is a positive attitude towards promotions implemented by banks to their customers, where they usually buy.

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Promotional strategies through BTL techniques identify target groups, then long-term cooperation or partnership is established, customer needs are planned, new directions in banking operations are established, full banking packages are developed; therefore their use is essential in marketing campaigns.

BTL promotional techniques will impose combination with other promotional activities, which will implement the principle of transparency and cooperation with the media of mass communication in the distribution of accurate and timely information about the bank. On the other hand, the survey confirms the wider dimension of BTL techniques such as *meeting the demands* of customers by providing standard offer of products and services for different groups of target customers; *creating a customized system for individual customer*, including a full suite of products and services in accordance with international standards; *offering comprehensive solutions for clients* who have large number of individual requests for realization of direct, multiple collaboration to the bank; development of the sale system that *requires constant promotion of the standard package of banking products and services* and systematic approach to policy promotion, particularly with the implementation of one-to-one marketing, which each new bank product or service will become closer and clearer to customers. They will be easily comparable, more convenient and more diverse than those offered by the competition and increase the *share of the client* - "selling" multiple products to individual customer.

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**APPENDIX 1
QUESTIONNAIRE**

General questions:

1. Place of birth Hometown (city): _____

2. Gender/Sex: 1. Male 2. Female

3. Age

- A. 18-24 B. 25-29
C. 30-34 D. 35-44
D. 45-54 F. 55-64
E. 65 and more

Individual questions:

1. *Do promotional activities of banks affect on your choice of their services?*

- A) Yes, a lot
B) Yes, but not much
C) No, it does not affect (me) much
D) No, not at all

2. *Which of the following marketing activities affects most on your decision about which bank product or service to use?*

- A) TV campaign
B) Radio campaign
C) Direct communication with bank's representatives
D) Information of web site of the bank
E) Other

If your answer is "E", please specify what?

3. *How quickly do you spot direct promotional presentations of banks?*

- A) Significantly quickly
B) Significant quickly, but if they are intensive during specified period
D) Not very quickly
D) Generally I do not spot

4. *Do frequent meetings with bank promoters affect you to familiarize in details their products or services?*

- A) Yes, absolutely
B) Yes, but not completely
C) No

5. *is it important for you bank employees to pay more attention when you are interested in particular service?*

- A) Yes, it is very important
B) Yes, but it does not have great importance
C) No, it is not very important
D) No, it does not matter

6. *How do you assess organization of presentations for certain banking products or services that implement banks?*

- A) It is excellent
B) It is good but not enough
C) It is not very important to me
D) It is not significant for me

7. *What is the most appropriate place for you to obtain detailed information for particular bank offer?*

- A) Free telephone line
B) Location of frequency where you often go
C) In the bank branch offices
D) Through promo stands for particular events

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- E) Other _____
8. *Will receiving regular e-mails affect on your decision to use certain bank products or services?*
- A) Yes, completely
 - B) Yes, but not completely
 - C) I am not sure
 - D) No, not at all
9. *If you have an opportunity would you like to receive direct mail from the bank so as to know their latest offering?*
- A) Yes
 - B) No
10. *Have you recently noticed any bank promotion in the Republic of Macedonia, promoted itself through specific web techniques?*
- A) Yes, often
 - B) Yes, but not often
 - C) No, I have not heard that
 - D) No
11. *How do you evaluate banks' promotion through social media?*
- A) It is excellent
 - B) It is good, but not enough
 - C) It is not very important to me
 - D) It is not significant at all
12. *Would you like to attend banking services presentation where you usually buy (information on credit cards, installment payment, etc.)?*
- A) Yes
 - B) Yes, but only for certain services
 - C) No
13. *Do you think banks as financial institutions should provide gifts vouchers or organize competitions for their customers?*
- A) Yes, regularly
 - B) Yes, occasionally
 - C) No, it is not necessary
14. *Do you support banks that occur as sponsors/donors of certain cultural/sport events more than banks that do not have these activities?*
- A) Yes, always
 - B) Yes, but not always
 - C) No, but I would support in the future
 - D) No, I do not support at all
15. *Do you think that banks should have a 24-hour phone line to provide information for customers?*
- A) Yes, it is important
 - B) Yes, but it is not necessary
 - C) No, there is no need
16. *Which of the following do you find as the most appropriate technique to familiarize yourself with the products of a particular bank?*
- (In the order of 1 maximum to 5 minimum)**
- Direct mail
 - Free telephone info line
 - E-mail
 - Promotional stands in shopping malls
 - Entertainment/events organized by the bank
17. *What does affect on your decision to use a particular bank product/service?*
- A. Offering favorable interest rates
 - B. Professional bank attitude
 - C. Brand product (Visa, Master and so on.)

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G. Promotional events where I am explained the advantages of the bank

D. Suggestion from friends

18. How do you individually evaluate marketing communication of listed banks in Republic of Macedonia (1 very poor - 5 very good)

Statement	Very bad	Bad	Neutral	Very good	Excellent
Stopanska Bank	1	2	3	4	5
Sparkasse Bank	1	2	3	4	5
Komercijalna Bank	1	2	3	4	5
Tutunska Bank	1	2	3	4	5
ProCredit Bank	1	2	3	4	5
Halkbank	1	2	3	4	5

19. Please separately evaluate promotional activities offered by banks in the Republic of Macedonia (1 very poor - 5 very good)

Statement	Very bad	Bad	Neutral	Very good	Excellent
Promotional stands	1	2	3	4	5
Web site and social media	1	2	3	4	5
Entertainment	1	2	3	4	5
Representative gifts	1	2	3	4	5

20. Please carefully view the list and then evaluate the following statements (1 - absolutely agree, 4 - absolutely disagree).

Statement	I absolutely disagree	I partially disagree	I partially agree	I completely agree
I would participate in any interactive game of a specific bank	1	2	3	4
I currently use Android or I-tunes application of a specific bank on my mobile phone	1	2	3	4

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I often visit banks websites to obtain certain information	1	2	3	4
I use service - personal banker	1	2	3	4
I support the banks that offer support and sponsorship of cultural events	1	2	3	4

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DIRECTION FOR NATIONAL SUSTAINABLE PROSPERITY

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ABSTRACT

The purpose of this article is to offer a model of sustainable prosperity, based on the concept of sustainable competitiveness. Therefore, an extensive review of available literature and reports that directly or indirectly are related to the concepts of competitiveness and sustainability was performed. In doing so, we identified the drivers and analyzed their mutual influence. In this methodological approach is used tool name a Sustainability competitive index (OGI) developed by the WEF in order to analyze the practical application of the concept of sustainable prosperity. The findings suggest that the competitiveness (as synonyms for prosperity) of developing countries is vulnerable when it integrates both sustainable components (an environmental and social inclusion), although this is not the case in advanced countries. These findings should help countries and companies perceive the new challenges, trends and practices and to motivate them so that they will respond appropriately. Finally, the paper offers to policymakers, managers and other stakeholders directions for improvement of their policies and strategies for institutional reform, in order both to create a society in which citizens will want to live and be ready for the changes that will occur.

KEYWORDS: competitiveness, sustainability, sustainability prosperity framework, sustainability prosperity performance

JEL CLASSIFICATION: O150; O210; O380; O44; O57

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1. INTRODUCTION

This article intends to develop a model of sustainable prosperity. To that end, first are analyzed key concepts on which it relies, then its frame is built by the identified drivers and finally the possibilities for its practical application is reviewed. The discussion will provide building blocks to explain how we have built the concept of sustainable prosperity. The notion prosperity in many dictionaries is defined as “a condition of being successful or thriving; especially economic well-being, e.g. a period of prosperity for our nation”² or “the condition of prospering; success or wealth; a successful, flourishing, or thriving condition, especially in financial respects”³. So, prosperity is often associated with wealth, standard of living, or improvement of the quality of life. The first two forms of prosperity are strongly linked with Gross Domestic Product (GDP). According to the underlying economic theory the sum of the market value of all the final goods and services produced in a certain country during a given time period is measured by the GDP of that national economy. The third association with prosperity, the quality of life is a broader concept than economic production and living standards. It include not only wealth and employment but also other more intangible aspects that make up human life, such as the built environment, physical and mental health, leisure, safety, freedom, cultural resources, social life, quality and availability of education, etc. so, GNP does not seem to be helpful in measuring of it.

However, since the mid XX century, per capita GDP has been severely criticized⁴ as not adequately capturing social welfare and progress. Today it has been subject to much debate. Recently, two alternatives to the growth paradigm have been put forward, namely, “degrowth” and “a-growth”. Advocates of the de-growth movement⁵ disagree the centrality of the GDP as an overarching policy objective. They call for an

² www.merriam-webster.com

³ www.thefreedictionary.com

⁴ see the Appendix for criticisms of GDP and the supporting references in van den Bergh, J.C.J.M. 2011. “Environment versus Growth: A Criticism of ‘Degrowth’ and a Plea for ‘AGrowth.’” *Ecological Economics* 70 (5): 881-890.

⁵ see Martinez-Alier, J. et al. 2010. “Sustainable De-Growth: Mapping the Context, Criticisms, and Future Prospects of an Emergent Paradigm.” *Ecological Economics* 69 (9): 1741-1747. and Kallis, G. 2011. “In Defence of Degrowth.” *Ecological Economics* 70 (5): 873-880.

equitable downscaling of the economic production and consumption in order to achieve environmental sustainability, social justice and well-being. Also, they argue that the use this concept can to assure that society's throughput - natural resource use and waste - stay within the safe biophysical boundaries. The other alternative is "a-growth"⁶, a perspective which proposes to ignore or even "abolish" GDP as a welfare and progress indicator. This focuses on sound environmental, social and economic policies independently of their effects on economic growth. Although these two alternatives have a different interpretations and strategies for growth, they initiate issues related to alternative future welfare and quality of life models which indicate that the GDP has limited informative value in relation to the future potential of achievement and sustainability of inclusive development and the creation of wealth.

For the last 25 years, the World Commission on Environment and Development (WCED 1987) recognizes that growth is necessary, but unsustainable in the long run, unless it is both socially inclusive and environmentally sound. Therefore, the report, *Our Common Future*, published under the auspices of the United Nations by the Brundtland Commission in 1987 propelled the concept of "sustainability" and launched a new agenda that voiced new and urgent environmental concerns. It indicated issues related to deforestation, the loss of biodiversity, desertification, the enhanced greenhouse effect, and the effects of poverty on the environment in many developing countries. It thereby challenged many of the fundamental goals and assumptions of the conventional, neoclassical economics of growth and development that often come at the expense of the environment. However, although initially this concept focused mainly on the environmental consequences of development, it has evolved significantly over time. Today it is widely accepted that the sustainability integrates economic, social and environmental dimension that have overlapping within themselves.

Motivated by the prosperity model perspective, advocates of the concept of competitiveness try to understand how these aspects of sustainability relate to

⁶ see van den Bergh, J.C.J.M. 2011. "Environment versus Growth: A Criticism of 'Degrowth' and a Plea for 'AGrowth.'" *Ecological Economics* 70 (5): 881-890.

competitiveness and productivity. The concept of competitiveness aims to capture the economic development process as a necessary condition for the improvement of the living standard and for the determination of the level of productivity of a particular country. It can be noted that “the level of productivity sets the sustainable level of prosperity that can be earned by an economy”.⁷ However, little is known about how both aspects of sustainability (environment and social) relate to competitiveness and productivity and hence the level of sustainable prosperity. To this end the World Economic Forum (WEF) has started to include sustainability aspects in its flagship Global Competitiveness Report (GCR), beginning with the 2011-2012 edition. The central idea is to assess the changes in national competitiveness when sustainability is taken into consideration. As a result of these efforts WEF developed a new concept named as Sustainable Competitiveness and consequently new index, the Sustainable Competitiveness Index (SCI),⁸ as a measurement tool for national sustainability competitiveness. The structure of concept provides an understanding of the idea of national sustainable prosperity and its drivers. While, the SCI scores give an overview what we do now and what we need to do to create better future and sustainable prosperity. Moreover, by comparing the outcomes of the sustainable competitiveness analysis, the SCI aims to contribute to the discussion of what policies can help a country to identify and develop suitable development models adapted to its special characteristics in order to achieve sustainable wealth creation. In addition, it identifies opportunities for quality growth, better quality of life and new way of economic development.

To understand fully the concept of sustainable prosperity, its components and drivers are elaborated in the text below, through three main sections as follow: foundations of the national sustainable prosperity, the frame of sustainable prosperity

⁷ see Sala-i-Martin et al., 2008, Chapter 1.1 *The Global Competitiveness Index: Measuring the Productive Potential of Nations*. The Global Competitiveness Report 2008-2009, World Economic Forum 2008, Geneva, p. 3

⁸ see Blanke, J., et al. Chapter 1.2 *The Long-Term View: Developing a Framework for Assessing Sustainable Competitiveness*, The Global Competitiveness Report 2011-2012, World Economic Forum 2012, Geneva, p. 51-74

concept and the national sustainable prosperity performance. Finally, the conclusion suggests directions that countries and companies can adopt the new model of development to be their practice.

2. THE FOUNDATIONS OF SUSTAINABLE PROSPERITY

Based on the above observations the defining the concept of competitiveness and sustainability are a starting point to understand the foundations of sustainable prosperity and accordingly to it the term "quality growth".

2.1. Competitiveness

In an effort to define competitiveness, more definitions exist and, therefore, there is no unique and commonly accepted definition of the concept. Generally, competitiveness in a traditional approach is considered on two levels: micro-economic (firm level) and macro – level (national competitiveness). On the *firm level*, competitiveness can be taken as its ability to do better firm strategies and rivalry between firms based on non-price factors (as technology, innovation, skills, knowledge, human capital etc.) as main inputs to reaching productivity. This view is supported by Porter who emphasized the role of productivity to an extent that productivity is the only meaningful concept of competitiveness at the national level.⁹ He believes that sustainable improvement in national prosperity occurs when there is an improvement in capacity of micro level or with other words when the companies produce valuable goods and services using efficient methods. The productivity, the central driver of the cross-country differences in prosperity as according to Porter is "the measure of the value of goods and services produced per unit of the nation's human, capital, and natural resources. It depends both on the value of nation's products and services, measured by the prices they can command in open markets and the efficiency with which they can be produced".¹⁰ It is expected to underlie higher quality of products,

⁹ see Porter, M. E. 1985. *Competitive Advantage*, New York, NY, USA: The Free Press, and Porter, M. 1990, *The Competitive Advantage of Nations*. New York: The Free Press, p. 6

¹⁰ Porter, M., *Building the Microeconomic Foundations of Prosperity: Findings from the Business Competitiveness Index*, The Global Competitiveness Report 2003-2004, World Economic Forum 2003, p. 31

new technology and production efficiency, all of which have important roles in explaining the nation's position on the international market. In line with the statements that productivity is nested in competitiveness, Aiginger gives new and broader definition. He says that competitiveness is "ability of a country or location to create welfare" which requires both an "outcome assessment" as an achievement of operationalization and "process assessment" as approach to investigate in production and technology, while the broader assessments include "distributional, social and ecological goals".¹¹ During it, he identifies unemployment, low participation rate and social inequality as factors that may undermine the rise of productivity of a nation.

The other view, the *national competitiveness* view, refers to the macroeconomic perspective. Using this approach numerous variations of definitions exist in literature. In some, competitiveness is related to the extent to which the country is able to adapt the policies that directly affect the ability of companies to compete internationally and to provide rise of standard of living to its citizens. So, OECD define competitiveness as "the degree to which a nation can, under free and fair market conditions, produce goods and services that meet the test of international markets while simultaneously maintaining or expanding the real incomes of its citizens".¹² In line with this WEF in the GCR defines competitiveness as "the set of institutions, policies, and factors that determine the level of productivity of a country".¹³

In practice, policymakers, in both advanced and developing countries, frequently link competitiveness to objectives of national economic policy such as "jobs, opportunity, and prosperity". For example: "The President's Council on Jobs and Competitiveness was created to advise the President [.....] ensure the competitiveness of the US and on ways to create jobs, opportunity, and prosperity for the American people"¹⁴. The second example reflects to the statement from a developing country:

¹¹ Aiginger, K. 2006. "Competitiveness: From a Dangerous Obsession to a Welfare Creating Ability with Positive Externalities," *Journal of Industry, Competition and Trade*, 6 (2), p 174

¹² OECD. 1992. *Technology and the Economy: The Key Relationships*. Paris, France: Organisation for Economic and Co-operation Development, p. 237

¹³ The Global Competitiveness Report 2007-2008, World Economic Forum 2007, Geneva, p. 3

¹⁴ <http://www.whitehouse.gov/administration/advisory-boards/jobs-council>, accessed October 22, 2014

“National Council for Competitiveness and Entrepreneurship of Macedonia establishes direct dialogue and cooperation between the business community, educational institutions and Government, in order to improve the competitiveness and innovation of the domestic economy and increase the standard of living and quality of life of the citizens”¹⁵. Similarly: “An economy is competitive if its population can enjoy high and rising standards of living and high employment on a sustainable basis. More precisely, the level of economic activity should not cause an unsustainable external balance of the economy nor should it compromise the welfare of future generations”.¹⁶

In the last decade, the above mentioned views of competitiveness are enhanced to a new perspective that includes the effect of technology and innovation. Various studies¹⁷ support the positive relationship between the technology factor and competitiveness. Fagerberg et al.¹⁸ found that technology competitiveness is one of the main explanations behind the continuing good growth performance of the Asian tigers relative to other major country groups.

Concluding this section it would be proper to mention that numerous definitions exist for the concept competitiveness. When all above definitions are merged, the conclusion is that the company’s productivity is root of competitiveness and growth potential of economies increases as competitive profiles of their companies shift towards products of higher technological and innovative intensity. Thus the innovation and new technologies becomes critical determinants of continuous operational improvement, creating and then commercialize new products and processes as now advantage. While both approach of competitiveness (firm and country level) are different, yet their ultimate goal is maintaining and increasing the real income of

¹⁵ <http://vlada.mk/node/5322>, accessed October 22, 2014

¹⁶ European Commission, *European Competitiveness Report*, 2000-2002

¹⁷ Wignaraja classifies the technology and innovation as a third approach and handles this view in detail. See Wignaraja, G. 2003. *Competitiveness analysis and strategy*, IN Wignaraja G. (Ed.), *Competitiveness Strategy in Developing Countries*, Routledge, New York, 16-60

¹⁸ Fagerberg, J., et al. 2005. *The competitiveness of nations*, DRUID Tenth Anniversary Summer Conference 2005 on Dynamics of industry and innovation: organizations, and systems, Copenhagen, Denmark

citizens and new jobs that usually reflected in the standard of living, economic growth and prosperity.

2.1.1. The frame of competitiveness and GCI

Based on the WEF definition for competitiveness, GCR offers an important tool named Global Competitiveness Index (GCI). The GCI frame covers comprehensive set of aspects relevant to competitiveness which help countries “to understand the key factors that determine its economic growth”¹⁹. This tool is defined through three main criteria, subdivided in 12 pillars of competitiveness, representing a total of 115 indicators. These criteria are referred to as “basic requirements” (which includes two pillars, institutions and infrastructure), “efficiency enhancers” (which includes education levels, market mechanism and size, labor flexibility, financial market liberalization and technology adaption), and “innovation and sophistication (which includes market maturity and R&D).

On this basis and its indicators, the GCI enables rankings a large number of countries (148 in 2013) in the world. In this manner countries can understand “why some countries are more successful than others in raising income levels”.²⁰ These insights can help in the formulation of improved national economic policies and institutional reforms.

2.2. Sustainability

It is now more than 30 years since the Report of WCED, *Our Common Future*, emphasized the need for a sustainable way of life, which not only addresses current environmental challenges but also ensures a secure society well into the future²¹. The main implication of using this idea is that unsustainable production and consumption by the present society will degrade the ecological, social, and economic basis for future generations, whereas a sustainable development involves ensuring that future generations will have the means to achieve a quality of life equal to or better than the

¹⁹ see Schwab, K. *Preface*, GCR 2012-2013, World Economic Forum 2012, p. xiii

²⁰ Ibid, p. xiii

²¹ see Brundtland, H. G., 1987, *Our Common Future*, United Nations World Commission on Environment and Development (WCED)

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present. In order to improve the sustainability by countries and companies are expected to implement the goals presented in Table 1.

Table 1: The sustainability goals

Economic

An economically sustainable system must be able to produce goods and services on a continuing basis, to maintain manageable levels of government and external debt, and to avoid extreme sectoral imbalances which damage agricultural or industrial production.

Environmental

An environmentally sustainable system must maintain a stable resource base, avoiding over-exploitation of renewable resource systems or environmental sink functions, and depleting non-renewable resources only to the extent that investment is made in adequate substitutes. This includes maintenance of biodiversity, atmospheric stability, and other ecosystem functions not ordinarily classed as economic resources.

Social

A socially sustainable system must achieve distributional equity, adequate provision of social services including health and education, gender equity, and political accountability and participation.

Source: Harris, J. 2000. Basic Principles of Sustainable Development, Working Paper 00-04, Global Development and Environment Institute. Tufts University, Medford, p. 5

However, it seems that the governments not have made enough the economy and companies to incorporate sustainability factors in their work. As a result, today the world faces greater challenges in terms of economic, environmental and social issues. In terms of *economy*, although overall GDP per capita has increased, it is distributed unequally between regions²². Dasgupta argues that economic growth is unsustainable in poor countries, partly because it is sustainable in wealthy countries and partly because countries that export resources are subsidizing the consumption of importing countries.²³ Second, under public pressure many governments are faced with the challenge to implement policies and measures that will positively impact the environment²⁴ in the hope that what remains of our common "mother nature" will be

²² see Ortiz, I., Cummins, M. 2011. Global Inequality: *Beyond the Bottom Billion – A Rapid Review of Income Distribution in 141 Countries*, UNICEF Policy and Practice

²³ Dasgupta, P. 2002. Is contemporary economic development sustainable? In *Ambio* 31(4):269-271.

²⁴ see Silveira, J. Stacy, 2001, *The American Environmental Movement: Surviving Through Diversity*, 28 B.C. Env'tl. Aff. L. Rev. 497

protected from destructive activities of individuals and an organization. Regarding of *social* issues as never before in the world there is a concern about the numerous events and challenges that put into question existing development model. These issues refer to the rise in unemployment in many advanced and less advanced economies. This in turn reflects social - economic inequality and opportunities within a country as well as between countries. On the other hand, this state of non-perspective can increase the level of concern among young educated population, which it can manifest in different ways, such as the events what has come to be known as the Arab Spring revolution in 2011. Finally, the *environmental* and *ecological* challenges are connected with the reduction of natural resources. The industrial activities over the last century, and the ruthless exploitation of natural resources (forests, coal, minerals, oil egg.) have caused serious *environmental* and *ecological* problems that threaten human survival. The list²⁵ includes global warming, acid rain, ozone depletion, natural resource scarcity, air pollution, toxic wastes, loss of biodiversity, and industrial accidents. The fact that natural resources are not renewable and many vital resources, like water, certain minerals and metals are scarce (or are set to become scarce in the near/medium future) it is clear that the wellbeing of present and future generation crucially depends on how society uses its resources.

2.2.1. The frame of sustainability: SD indicators

There are many tools and methodologies designed to measure progress towards SD. One of the most popular tools is the UN's indicators of sustainable development (SD indicators).

Table 2: CSD indicator themes

CSD indicator themes

Poverty	Natural hazards	Economic development
Governance	Atmosphere	Global economic partnership
Health	Land	Consumption and production patterns
Education	Oceans, seas and coasts	
Demographics	Fresh water	
	Biodiversity	

²⁵ see Shrivastava, P. 1995. 'Environmental technologies and Competitive advantage, *Strategic Management Journal*, 16: 183-200

Source: UN, 2007, *Indicators of Sustainable Development: Guidelines and Methodologies*, Third Edition. New York: The United Nations publication p. 9

This tool is developed, with the aim to measure sustainable development in its entirety, taking into account the multi-dimensional and integrated nature of sustainable development. The SD indicators²⁶ are embedded in a theme-based framework (see Table 2) so that the core set of 50 indicators are grouped into 14 themes with 44 sub-themes.

In general this thematic framework of indicators are considered to be a good instrument in monitoring of the progress of goals set in national strategies for sustainable development and to show how well a system is working towards the defined goals. Also it should allow decision-makers to assess the gap or distance between the actual and desired SD state and to facilitate the adoption policy decisions aimed at achieving sustainable development goals. In practice countries have different perspective of SD and the selection of SD indicators for the assessment of national sustainable development tends to vary by country. So, countries implement national indicator sets and methodologies for measurement of sustainable development. This practice can be supported by several reasons. First, countries do not share the same history, culture, level of economic and social development or physical conditions and develop. On other hand needed information for it are multiple and originate from many sources – public and private, which complicates the SD monitoring progress. So, due to these reasons it is difficult for countries to agree on a common core set indicators for sustainable development to be applied all nations and there is no agreed indicator to measure sustainable development of nations. Therefore, some scholars stated that “novel methodologies based on new types of statistical approaches is need”²⁷. It would allow easily combining of SD indicators through accounting framework, understanding of relationships of the three aspects of sustainable development and their overlapping.

²⁶ see UN. 2007. *Indicators of Sustainable Development: Guidelines and Methodologies*, 3ed, New York

²⁷ see Stevens, C. 2005, *Measuring Sustainable Development*, Statistics brief, OECD, p. 7 also and Chamhuri, S., and Rabiul, I., 2012, Concepts, Approach and Indicators for Sustainable Regional Development, *Advances in Environmental Biology*, 6(3), p. 978

In this way, indicators can be used to compare the relative situations of the countries, quickly comparing between different countries and assessment of their strengths and weaknesses that could help to identify domains where political intervention is needed.

2.2.2. Strategy "pathways to sustainability future"

In line with the effort to create pathways to sustainability future by companies, especially those in the industrialized and developing countries are expected to practice strategies that will reduce environmental impact and thereby make profit.²⁸ Some economists and strategists have studied how companies can reduce environmental impact and simultaneously to shape competitive advantages. The so-called Porter hypothesis suggests that stringent, well-designed environmental regulations could actually enhance the competitiveness. Consequently Porter and van der Linden believe that higher environmental standards stimulate innovation and upgrading of technologies, making companies more efficient. However, as they emphasize, innovation is more than just technological change and can take various forms including "a product's or service's design, the segments it serves, how it is produced, how it is marketed and how it is supported".²⁹ Also, they argue that pollution is often a waste of resources "incomplete material utilization and poor process controls, which result in unnecessary waste, defects, and stored materials"³⁰ and that a reduction in pollution may lead to an improvement in the productivity with which resources are used.

During to the multiple crises that the world has been facing in recent years, the United Nations General Assembly and several UN agencies underscored that the crisis represented an opportunity to promote the concept of "green economy" as a new economic growth paradigm that is friendly to the earth's ecosystems and can also contribute to poverty alleviation. The United Nations Environment Programme (UNEP) defines a green economy as one which results in "improved human well-being and

²⁸ see Stuart L. H., 1997, *Beyond Greening: Strategies for a Sustainable World*, Harvard Business Review, January-February 1997, Reprint 97105 :70-75

²⁹ Porter, M. E. and van der Linde, C. 1995a. "Toward, a new conception of the environmental - Competitiveness relationship. *Journal of Economic Perspective* 9 (4), p. 98.

³⁰ Porter, M. E. and van der Line, C. 1995b. Green and competitiveness: Ending the Stalemate, *Harvard Business Review*, pp.122

social equity, while significantly reducing environmental risks and ecological scarcities".³¹ This concept differs from sustainable development in a subtle but important respect because it responds to the "growing recognition that achieving sustainability rests almost entirely on getting the economy right".³² In its simplest expression, a green economy can be thought as of one, which is low carbon, resource efficient and socially inclusive. In terms the growth in income and employment, it should be driven by public and private investments that reduce carbon emissions and pollution, enhance energy and resource efficiency, and prevent the loss of biodiversity and ecosystem services. These investments need to be catalyzed and supported by "targeted public expenditures, policy reforms and regulation changes".³³ The challenge is thus to achieve growth in conventional national income without large and irreversible negative impacts on the environment. In terms of it how to achieve it scholars offer different suggestions and instruments. Some of them propose that the government should redirect the economy towards sustainable green growth paths by introducing taxation in order reduce the overuse of natural assets, and later to use both instruments "getting the prices right and stimulating innovations."³⁴, while others believe that it can to achieve through R&D subsidies rather than carbon taxes.³⁵

Although those scholars propose different approaches for the protection of natural capital they however are agree that "more rapid green growth is inconceivable without innovation"³⁶ as well as that with "strategically crafted environmental policies can achieve environmental sustainability at a low cost, and even help stimulate growth"³⁷. Evidence suggests, for example that China's economic growth has come with a

³¹ UNEP, 2011. *Towards a Green Economy: Pathways to Sustainable Development and Poverty Eradication - A Synthesis for Policy Makers*, p. 2,

³² Ibid, p. 2

³³ Ibid, p. 3

³⁴ van der Ploeg and R. Withagen, C, 2012, *Green Growth, Green Paradox and the global economic crisis*, Environmental Innovation and Societal Transitions 6, p. 118

³⁵ see Acemoglu D, P. et al. 2012. "The environment and directed technical change", *American Economic Review*, 102(1): 131-166.

³⁶ Mark A. D. and Sharma, S., 2012. *Green growth, technology and innovation*, Poverty Reduction and Economic Management Network, The World Bank, Policy Research Working Paper 5932, p. 2

³⁷ Toman, M. 2012. "Green Growth": *An Exploratory Review*. Development Research Group, The World Bank, Policy Research Working Paper 6067, p. 2

relatively lesser increase in emissions in terms of it how economic growth had happened earlier in Europe and North America because China has been able to “leapfrog” to technologies that are much cleaner than Europe and North America were using at similar stages in their development. Although its emission rates per GDP are still high, they are “decreasing and have been halved in the last decade”.³⁸

In contrast to the earlier studies³⁹ that report an inverse relationship between environmental regulations and productivity (or productivity growth), by introducing lags of three or four years between changes in the stringency of environmental regulations and any resulting changes in productivity, Lanoie et al. found that stricter regulations led to modest long-term gains in productivity.⁴⁰ This firstly by reducing productivity in year one, then having a slightly positive effect in year two, and then resulting in more positive outcomes in years three and four, thus more than offsetting the first year’s loss - in a sample of seventeen Quebec manufacturing sectors. However, they show that this effect is more important in industries that are highly exposed to outside competition.

It should be emphasized here that concerns about sustainability are not new. Now it is widely accepted that economic growth and wealth creation can have adverse impacts on the non-financial assets of a country and the region. The strategy “pathways to sustainability future” relies on stricter and even more prescriptive but well-designed environmental regulations. The basic argument is that this form of regulations stimulates innovation, adoption of new technologies and research and development. Some studies confirm that in practice there is a positive relationship between strict environmental regulations and increasing productivity, especially in industries where competition is expressed. Thus, the regulations can enhance a country’s

³⁸ Najam, A., Runnalls, D., Halle, M., 2007. *Environment and Globalization: Five propositions*, International Institute for Sustainable Development, p. 23

³⁹ see Ambec, S., & Barla, P. 2006. "Can Environmental Regulations be Good for Business? An Assessment of the Porter Hypothesis," *Energy Studies Review*: 14 (2): 42-62

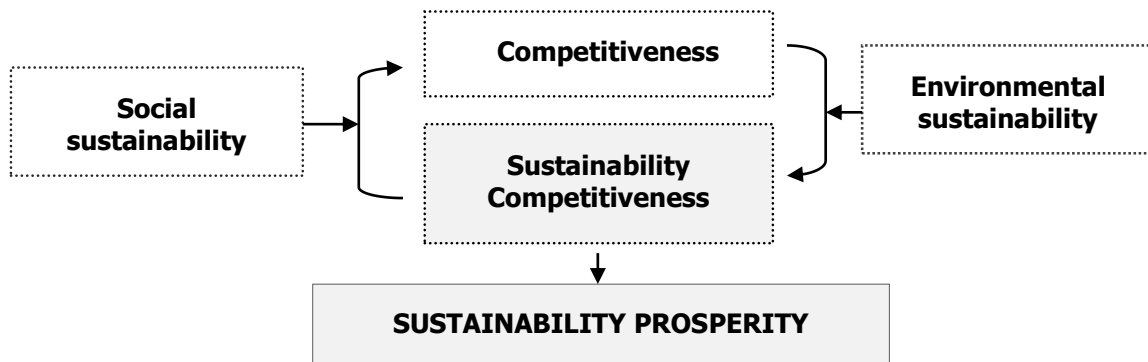
⁴⁰ Lanoie, P. et al. 2008. "Environmental Regulation and Productivity: New Findings on the Porter Hypothesis", *Journal of Productivity Analysis*, 30: 121–128.

competitiveness, productivity and to simultaneously provide quality growth. Moreover, these positive changes will spill over into positive changes in all aspects of sociality.

3. THE FRAME OF SUSTAINABLE PROSPERITY CONCEPT

The concept of sustainable competitiveness (SC) is a starting point in understanding the concept and drivers of National Sustainable Prosperity (NSP). This new concept captures from previous concepts, the competitiveness and the sustainability, so that the sustainability is defined in economic, social, and environmental through the prism of the competitiveness (see Figure 1). Integrating the sustainability into competitiveness derives from the idea that "competitiveness on its own, may not lead to sustainable levels of prosperity [...] and that competitiveness is a necessary, but not sufficient condition for prosperity".⁴¹

Figure 1: The Structure of National Sustainability Prosperity



The WEF in the GCR defines the concept of *sustainable competitiveness* as:⁴² "set of institutions, policies, and factors that make a nation remain productive over the longer term, while ensuring social and environmental sustainability". Also WEF gives two new definitions for the two sustainable components: social cohesion and environmental sustainability - important over the longer term and are essential for a sustainability perspective. The *environmental sustainability* is defined as "institutions, policies, and factors that ensure an efficient management of resources to enable

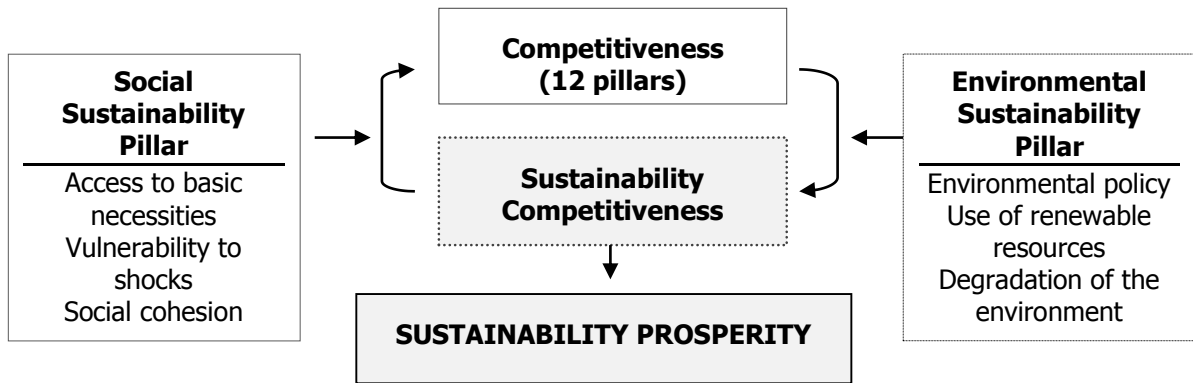
⁴¹ see Osorio, B., Bilbao et al. 2012, Chapter 1.2 *Assessing the Sustainable Competitiveness of Nations*, GCR 2012-2013, World Economy Forum 2012, p. 53

⁴² *ibid*, p. 53

prosperity for present and future generations” while the *social sustainability* as "institutions, policies, and factors that enable all members of society to experience best possible health, participation, and security; and to maximize their potential to contribute to and benefit from the economic prosperity of the country in which they live".⁴³

From all above definitions can conclusion that national sustainability prosperity does not occurs when there is increased productivity, but rather when there is an efficient use and management of all the resources in any kind of production of goods so that the growth potential of countries should increases of a way that will ensure social and environmental sustainability of current and future generations. Therefore, deeper understanding of key sustainability prosperity drivers is needed as well as quality institutions and strongly policies for meeting of this the challenges.

Figure 2: The sustainability prosperity framework



Source: Adjusted according to *Global Competitiveness Report 2012-2013*, p. 52

Consequently, the framework of the Sustainable Prosperity concept⁴⁴ (see Figure 2) is composed by almost all drivers placed in 12th pillars⁴⁵ of the *competitiveness* already

⁴³ Ibid, p. 53

⁴⁴ The framework of SCI provides a deeper understanding of key sustainability prosperity drivers.

⁴⁵The concept of competitiveness relies of 12 pillars as: institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labor market efficiency, financial market development, technological readiness, market size, business sophistication, and innovation. See Xavier, S. Martin et al. Chapter 1.1 *The Global Competitiveness Index 2011–2012: Setting the Foundations for Strong Productivity*, GCR 2011-2012, p. 3-9

mentioned in this paper (see title The frame of competitiveness and GCI), important over the short- to- medium term and a number of *sustainable variables* - important over the longer term (e.g., demographics, social cohesion, and environmental stewardship) which affect the national productivity and are essential for a sustainability perspective.

Table 3: The social sustainability drivers

Access to basic necessities	Vulnerability to shocks	Social cohesion
<ul style="list-style-type: none"> • Access to sanitation • Access to improved drinking water • Access to healthcare 	<ul style="list-style-type: none"> • Vulnerable employment • Extent of informal economy • Social safety net protection 	<ul style="list-style-type: none"> • Income Gini index • Social mobility • Youth unemployment

Source: The Global Competitiveness Report 2013-2014, World Economic Forum, p. 63

As shows the Table 3, the *Social sustainability pillar* includes three categories of factors such as: (1) access of population to basic necessities (lack of access to basic necessities indicates a state of poverty), (2) vulnerability of population to economic exclusion and (3) social cohesion. The first category, *access of population to basic necessities*, includes three factors: (1) access to sanitation, (2) access to improved drinking water, and (3) access to healthcare services. These factors reflect extent of the inclusion as well as the fulfillment of basic physical needs. The second category is named *vulnerability of population to economic exclusion*. The term *vulnerability* means “the degree to which a country’s competitiveness is susceptible to negative consequences through potential future adverse environmental, social, or economic shocks”⁴⁶ that could be sources of instability tomorrow, and thus erode their competitiveness over time. This category includes three factors as: (1) vulnerable employment, (2) the extent of informal economy, and (3) social safety net protection. The vulnerable employment factor relates to the people who are self-employed in a small business or are in a small family business that may provide income levels

⁴⁶ Blanke, J. et al. 2011. Chapter 1.2 *The Long-Term View: Developing a Framework for Assessing Sustainable Competitiveness*, GCR 2011-2012, World Economic Forum 2011, Geneva, p. 52

insufficient to meet the living standards of the country of citizenship and can prove unstable in times of economic difficulties. The extent of the informal economy provides a sense of how well integrated the workforce is into official institutions structures. Third factor, such as social safety net protection leads to a sense of financial security without falling into poverty traps.

In the third category, *social cohesion* also include three factors as: (1) the income Gini index (reflect income inequality among individuals or households that can cause that they are hardly to be able to cover basic necessities), (2) social mobility (reflects the opportunities that allow subsequent generations to improve their condition regardless of socio-economic status of their parents and measure the freedom to pursue human development), and (3) youth unemployment (reflects a failure to mobilize existing resources and build productive skills, and it suppresses aggregate demand, eroding business confidence and therefore the prospects for investment and employment creation). The last two factors, unemployment and inequality can also converge to spark political instability due to low expectations for the future.

Table 4: The environmental sustainability drivers

Environmental policy	Use of renewable resources	Degradation of the environment
<ul style="list-style-type: none"> • Environmental regulations (stringency and enforcement) • Number of ratified international environmental treaties • Terrestrial biome protection 	<ul style="list-style-type: none"> • Agricultural water intensity • Forest cover change • Fish stocks' overexploitation 	<ul style="list-style-type: none"> • Level of particulate matter counteraction • CO2 intensity • Quality of the natural environment

Source: The Global Competitiveness Report 2013-2014, World Economic Forum, p. 63

Table 4 shows the *Environmental sustainability pillar* and the most relevant factors placed in different categories such as: (1) environmental policy, (2) use of renewable resources and (3) degradation of the environment. This pillar measures the extent to which economies have instituted the types of policies necessary to protect the environment from degradation.

The first category, *environmental policy* includes three important factors: (1) the stringency and enforcement of environmental regulation which reflect country's

commitment to protect natural capital; (2) terrestrial biome protection which reflects official protection of land area of each habitat type and (3) number of key international environmental treaties which reflects the country's level of engagement with environmental issues and thus its willingness to become involved in international efforts toward addressing global environmental challenges. Indicator of this group of factors reflects the extent to which the country has the political will to respond to environmental issues of a consistent way and to show it in their government agenda.

The second category, *use of renewable resources* also includes three factors such as: (1) agricultural water intensity (its indicator reflects efficient using of water in agriculture sector); (2) forest depletion (its indicator reflect change in forest cover and forest loss) and (3) exploitation of fishing grounds. These resources are critical for survival of the country and its good management should be guided by the aim to ensure the need of future generations. The third category, *degradation of the environment* includes the drives which can cause serious damage to human health while destroying the ecosystem as: (1) the level of particular matter concentration, should be constantly monitored by local authorities in many countries because reflects air pollution; (2) the quality of the natural environment, which reflects the behavior of companies to local environment, and (3) CO₂ intensity which reflect the efficiency of energy use in relation to the emissions it produces.

In the near future it is expected that toward above categories will be added new elements critical for sustainable competitiveness, such as: the incidence of political violence and civil war; market imbalances or "bubbles"; natural disasters; environmental damage and resource depletion; better measures of food security; non-communicable diseases, worker protection, social participation and respect for core human rights, as well as discrimination and the treatment of minority populations. It is expected that the involvement of these sustainability elements will have positive affect the national productivity and making a quality growth seen in the long term.

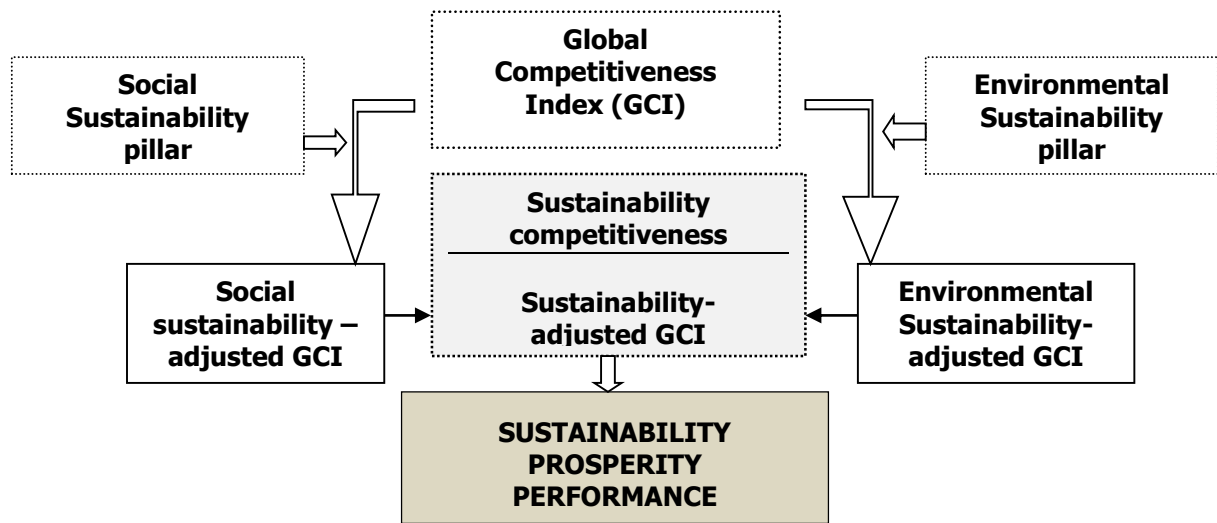
At the end of this section it is important to note that the above mentioned and analyzed drivers affect the productivity in long term and their practicing enables quality

growth of economies and sustainability prosperity. Simultaneously, they give directions for creating politics for sustainable prosperity and from this viewpoint seem that polices maker, managers and other stakeholder can make the rights thing at the right time for its society and our Mother Earth.

4. THE NATIONAL SUSTAINABLE PROSPERITY PERFORMANCE

Since 2011 WEF developed a tool called Sustainable Competitiveness Index (SCI) with that the countries are assessed for their ability to generate prosperity for their citizens in a sustainable way.

Figure 3: The structure of the sustainability-adjusted GCI



Source: Adjusted according to Global Competitiveness Report 2012-2013, p. 52

Before SCI appeared, competitiveness was measured solely by economic activities and increased wealth. Now the GCI takes in account sustainability factors which can affect the national productivity (heart of competitiveness) in the long-term and computes each indicator weighing according to its relevance in achieving and sustaining sustainable wealth. Hence emerge two sustainability-adjusted measures of competitiveness: social sustainability-adjusted GCI and environmental sustainability-adjusted GCI, while average of these two sustainability-adjusted indexes result in the

SCI). Consequently the level of sustainable national prosperity (see Figure 3) is equally the score of national sustainability competitiveness.

From the 142 economies in 2011 and 144 economies in 2012 covered by the GCI⁴⁷ on less than 80 countries (such as those in the OECD, G-20 and the European Union) SCI is measured. The preliminary scores show that GCI of countries with a lower living standard (developing countries) is vulnerable to the sustainability factors relative to other developed countries (e.g. EU countries). So score of their sustainability competitiveness decreases compared to other countries. Also, measuring of national sustainability competitiveness show that GCI scores can go up or down (changes between -20% to +20%), depending on the sustainable performance of country. Thus the countries with strong sustainable performance will be better ranked versus countries with poor sustainable performance.

With the intention to perceive the impact of sustainability and to compare sustainable competitive indicators among countries Table 5 shows scores of adjustment GCI by sustainability factors for 2012. For example, GCI 2012 for Switzerland has score 5.72, but based on the impact of social and environmental factors score 6.85 is obtained, as an average of its two sustainability-adjusted scores. This country belongs in the group of countries with GCI score changes by > +15% to + 20%. Switzerland leads the ranking of the SCI due to implementation of best environmental policies, well managed renewable resources, effective use of resources in the economy, and sound social cohesion. The other countries in this group are: Finland, Netherlands, Germany, Denmark and Austria. The Nordic countries as Sweden, Finland, and Denmark, which are in the group of top 20 countries have put into place very stringent and well-enforced environmental policies, which lead to positive outcomes. Moreover, these countries have social cohesion indicators that are sustainable overall. A larger number of EU countries (e.g. Sweden, United Kingdom, Belgium, France, Slovenia) belong in the group of countries where GCI score changes by +5% to +15%. Those countries long have started to incorporate sustainability factors in their policies and corporate score

⁴⁷ See GCR 2011-2012, p.63 and GCR 2012-2013, p. 58-59

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cards, and actively pursuing new opportunities related to sustainable development. In addition to these practices are claims of many academics⁴⁸ which state that innovation is correlated with well-designed environmental policies and that they simultaneously support high productivity and sustainable prosperity. This argument is supported by the fact that EU countries meet, innovation and sophistication indicator in last decade.⁴⁹

Table 5: The national sustainable prosperity: scores according to the SCI

Country/ Economy	GCI 2012–2013 (Score from 1to7)		Social sustainability– adjusted GCI	Environmental sustainability – adjusted GCI	Sustainability- adjusted GCI	
	Rank	Score	Score	Score	Score	Direction
	Switzerland	1	5.72	6.83	6.87	6.85
20 EU countries	Top 20					↗
Macedonia	80	4.04	3.66	3.64	3.65	↘
Greece	96	3.86	3.59	3.82	3.71	⇒
Egypt	107	3.73	3.56	3.20	3.38	↘
Algeria	110	3.72	3.31	3.01	3.18	↓
Pakistan	124	3.52	2.84	2.96	2.90	↓

Note: Due to lack of data, only the 79 countries are covered out of 144 in the table of GCR 2012.

Key

↑ GCI score changes by > +15% to +20%

↘ GCI score changes by –5% to –15%

↗ GCI score changes by +5% to +15%

↓ GCI score changes by < –15% to –20%

⇒ GCI score remains stable between +5% and –5%

Different of this example, Macedonia's competitiveness has score 4.04, but when both sustainable components are included, the score decrease to 3.65. Macedonia belongs in the group of countries where GCI score changes in negative, by –5% to –15%. In terms of social and environmental sustainability Macedonia should improve on numerous gaps⁵⁰. For example, the country needs to conduct an energy audit in SMEs

⁴⁸ see van der Ploeg and Withagen, 2012; Acemoglu et al., 2012; Mark A. Dutz and Sharma, S., 2012; Porter and van der Linde, 1995a

⁴⁹ see GCR 2012-2013, p. 20

⁵⁰ see Stojanovska, S., 2013, Macedonia's sustainable competitive performance, *Journal of Sustainable Development* 14 (5), Integrated Business Faculty, Skopje, Republic of Macedonia, p. 77 – 90

and they should initiate energy efficiency in their companies; to organize a structure for Eco-Management and Audit Scheme (EMAS) and to inform the public about the possibilities of the scheme; to get accredited by a national certification body; to introduce a national eco-label for all product; to introduce mandatory packaging for waste management; etc. For increasing the social cohesion, Macedonia makes some efforts, but not enough to reduce the present differences and inequalities among the population. The country needs to overcome the challenges associated with the employment of unemployed young people, women and long-term unemployed to in order improve its low social cohesion. In the coming years Macedonia needs to overcome challenges associated with sustainable components and also with issues of competitiveness.

The countries from Arab Spring demonstrations as Egypt (score 3.73, rank 107) and Algeria (score 3.72, rank 110) have very low score of GCI and it positioned very low of ranking among 144 countries in 2012. According Sustainability-adjusted GCI, Egypt (score 3.38) belong in the group of countries where GCI score changes by –5% to –15%, while Algeria (score 3.18) in the group by < –15% to –20%. These two countries are a real example of the negative impact of social sustainability on national productivity and economic growth, when this dimension is ignored by government policies and practices. In this case, high percentage of educated but unemployed young population took to the streets in opposition to the existing economic structure and the oppressive regime. The sources of their discontent are ranging from frustration with economic conditions, to opposition to the political status quo, to lack of a sense of overall efficiency⁵¹.

Taken together, these observations suggest new guidelines for the development process. Although these scores by SGI are still preliminary, they give a general sense of country sustainable policies and activities and their national sustainable prosperity. By comparing the scores of the sustainable competitiveness analysis we note that the

⁵¹ see Michael Hoffman and Amaney Jama, 2012, The Youth and the Arab Spring: Cohort Differences and Similarities, *Middle East Law and Governance Journal* 4, p. 168–188

SCI aims at contributing to the discussion of what policies can help a country to identify and develop suitable development models adapted to its special characteristics in order to achieve sustainable wealth creation.

Concluding this section, it would be proper to mention that this useful tool helps to measure the extent of national sustainable prosperity of a number of countries in world. On this basis countries can begin to assess their ability to generate sustainable prosperity and to understand cross country differences in sustainable performance. Also, this index represents what we are doing in the present and what we are supposed to do in the future for correlating sustainable prosperity and quality growth.

CONCLUSION AND NEXT STEPS

This paper has discussed the idea that sustainable prosperity can to build the base on the concept sustainable competitiveness which is developed and supported by WEF. This possibility stems from integration of both the sustainable aspects (environmental and social inclusion) - important over the longer term the national productivity and are essential for a sustainability perspective - in the competitiveness concept. For this purpose discussion is provided of both concepts and their drivers.

From the discussion followed a few conclusions:

- competitiveness is a necessary for economic growth but not sufficient condition for sustainable prosperity;
- economic growth and wealth creation can have adverse impacts on the non-financial assets of a country and the region;
- well-designed environmental regulations are needed because it can enhance a country's competitiveness, productivity and to simultaneously provide quality growth, on the other hand these positive changes will spill over into positive changes in all aspects of sociality.
- the innovations and the new technologies have positive effect upon the competitiveness and sustainability, because the innovations are increasing productivity and that they are decreasing the negative influence on the

environment and social domains. Hence, the innovation capabilities of companies are becoming the basic pillars for sustainable competitiveness and sustainable prosperity of the economies.

In line with it is provided framework of sustainability prosperity which captures a number of drivers from competitiveness and both sustainable components, social inclusion and environment. In that manner is provided a deeper understanding of the key sustainability prosperity drivers. It should help countries to understand key sustainable drivers that affect the productivity over the longer term and to identify the drivers upon which they can develop environment and social politics and "quality growth".

Then, based on SCI index the countries are assessed for their ability to generate prosperity for their citizens in a sustainable way and their scores are analyzed and compared with each other. The findings suggest that:

- many countries at the top of the competitiveness rankings are also the best performers in many areas of sustainability.
- the analysis of the scores the SCI of advanced countries shows that their policies and practices relies on sustainable drivers, like environmental regulation, social inclusion and innovation, which is not the case with less developed countries.
- advanced countries have started to incorporate sustainability factors in their policies and are actively pursuing new opportunities related to sustainable development.

This article sends a clear message that the national objectives of increasing economic efficiency and material wealth must take into account social and environmental aspects and that sustainable prosperity and progress will depend on the balance between economic progress both social inclusion and effective use of natural resources. It illustrates that the countries there is no longer to concentrate only on economic growth. There is a positive trend the idea of sustainable prosperity to become unique challenge embraced in worldwide and its principles consistently to perform in order to provide our present and future the next generations.

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**INVESTIGATING THE ADEQUACY OF THE MACEDONIAN DEPOSIT
INSURANCE PREMIUM**

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ABSTRACT

A key function of a deposit insurance system is to give depositors prompt access to their insured deposits when a bank is closed. A deposit insurer's effectiveness in providing prompt reimbursement to depositors is critical for maintaining confidence in the banking system and financial stability. In order of providing its key function, every deposit insurance system should have an effective funding. In deposit insurance systems that use ex-ante funding, funds are most commonly collected through premium assessment from the financial institutions – members of the deposit insurance system. The height of the deposit insurance premium is very important issue. If a deposit insurance premium is set to low, the fund may not collect enough means for depositors' reimbursement. On the other site, too high deposit insurance premium will be unjustified burden to the financial institutions. The purpose of this paper is to investigate the adequacy of the deposit insurance premium of Republic of Macedonia. The premium adequacy is analyzed through comparative analysis with the deposit insurance premium of other countries and from the target reserve ratio point of view. The comparative analysis shows that Macedonian deposit insurance premium rate is among the highest premium rates not only among the European countries but on the world level as well. The analysis from the target reserve ratio point of view shows that the target level of the Deposit Insurance Fund Skopje has been achieved since 2010, so the premium rate should be set on a level that will allow maintaining of the achieved target reserve ratio. Because of the dynamic growth of the households' deposits maintaining the target reserve ratio of the Macedonian deposit insurance fund requires only a little lower premium rate than the regular i.e. the deposit insurance premium rate of Republic of Macedonia can be reduced to 0.65%.

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KEYWORDS: deposit insurance system, deposit insurance funding, deposit insurance premium, fund sufficiency, financial system of the Republic of Macedonia

JEL CLASSIFICATION: G20

1. INTRODUCTION

A deposit insurance system (DIS) refers to the set of specific functions (whether performed by a dedicated legal entity or not) inherent in providing protection to bank depositors, and their relationship with other financial system safety net participants to support financial stability.² The role of deposit insurance and deposit protection is undergoing important changes in light of the 2008/9 global crisis. Assumptions about the role of deposit protection in maintaining financial stability has evolved and its role in the safety net has been clarified and strengthened. The main purpose of the deposit insurance, as a part of the global financial stability framework, before the crisis, was protection of the small depositor, who doesn't understand and monitor the risk taken by the financial institutions. After the crisis, maintaining and strengthening the stability of the financial system was set as primary goal of the deposit insurance and protection of the small depositors as secondary (Bernet and Walter, 2009).

A key function of a deposit insurance system is to give depositors prompt access to their insured deposits when a bank is closed. A deposit insurer's effectiveness in providing prompt reimbursement to depositors is critical for maintaining confidence in the banking system and financial stability. (IADI, 2012) In order of providing its key function, every deposit insurance system should have an effective funding. Inadequate funding can lead to costly delays in resolving failed banks and to the loss of credibility of the deposit insurance system.

In deposit insurance systems that use ex-ante funding,³ funds are most commonly collected through premium assessment from the financial institutions –

² A financial safety net typically consists of prudential regulation and supervision, emergency lender of last resort, problem bank insolvency frameworks, and deposit insurance. In many jurisdictions, a department of the government (e.g. ministry of finance or treasury) is also included in safety net.

³ Over 80 per cent of deposit insurance systems are involved in ex-ante funding (IADI, 2009).

members of the deposit insurance system. The height of the deposit insurance premium is very important issue. If a deposit insurance premium is set to low, the fund may not collect enough means for depositors' reimbursement. On the other site, too high deposit insurance premium will be unjustified burden to the financial institutions. Since the financial institutions calculate the premium in the passive interest rates through their reduction and the passive interest rates have an effect on the active interest rate, unjustifiably high deposit insurance premium will have a negative impact on the financial markets interest rates.

The purpose of this paper is to investigate the adequacy of the deposit insurance premium of the Republic of Macedonia. The premium adequacy will be analyzed through comparative analysis with the deposit insurance premium of other countries and from the target reserve ratio point of view. The analysis should answer the question: "Can deposit insurance premium of Republic of Macedonia be reduced?" The rest of the paper is organized as follows. The main characteristics of the funding of the deposit insurance system of the Republic of Macedonia are presented in section 2. Empirical analysis are presented in sections 3 and 4 from which section 3 is focused on the comparative analysis and section 4 is focused on the premium adequacy analysis from the target reserve ratio point of view. The concluding remarks and the recommendations for further research are presented in the last section.

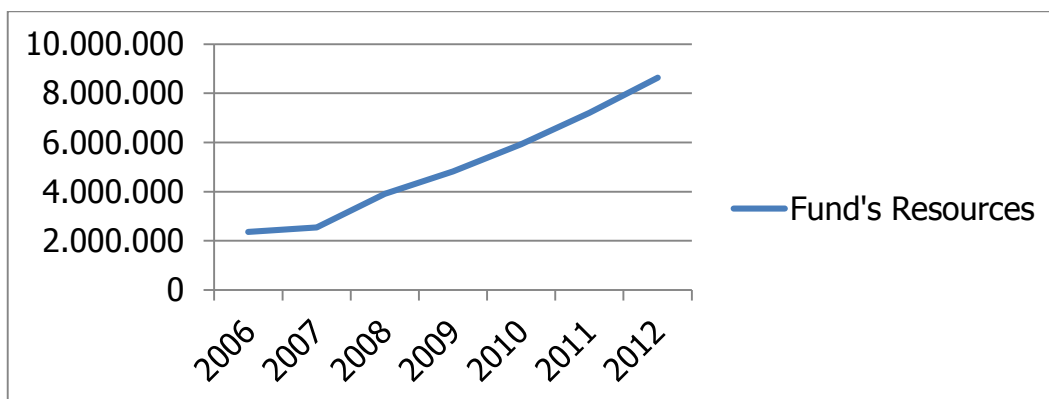
2. FUNDING OF THE DEPOSIT INSURANCE SYSTEM OF REPUBLIC OF MACEDONIA

The funding of the Deposit Insurance System of Republic of Macedonia is defined with the Law on Deposit Insurance Fund and the Statute of the Deposit Insurance Fund – Skopje. Article 6 of the Law on Deposit Insurance Fund predicts that the resources of the Fund shall be composed of the founding capital, collection of premiums for insurance of deposits and revenues from investments. This article determines ex-ante funding mechanisms i.e. funds accumulation prior to the actual

bank failure. Article 8 of the same law predicts the ex-post component of funding in case of a need of additional resources for depositors reimbursement.

The Deposit Insurance Fund of Republic of Macedonia has a target reserve ratio prescribe with the law. The target reserve ratio is set to 4% of the total deposits in the banks, foreign bank branches and saving houses in the Republic of Macedonia. The Fund is obliged to maintain the target reserve level, and when the resources of the Fund exceed this level the Managing Board of the Fund can pass a decision for termination of the premium payment obligation.

Figure 1: Resources of Deposit Insurance Fund – Skopje (2006-2012)



Source: Deposit Insurance Fund – Skopje: Audit Reports 2006-2012, available at:

<http://www.fodsk.org.mk/eng/report.asp>.

Figure 1 presents permanent increase of the Funds resources in the observed period. The average annual increase has been 25%. The largest part of the Fund is accumulated from the deposit insurance premiums collected by the banks and the saving houses. Since the deposit insurance premiums are calculated as percentage of the insurable deposits the increase of the resources is due to households' deposits increase. But the resources increase does not means greater target reserve ratio achievement since the target level of the resources is determined as fund's resources to household deposits ratio. In such case even with dynamic increase of the funds resources the achievement of the target level may have a negative trend. The table below presents funds resources to households' deposits ratio for the period from 2006 to 2012.

Table 1: Target Level Achievement

Year	2006	2007	2008	2009	2010	2011	2012
Fund's resources to households' deposits ratio	3.32%	2.71%	3.63%	3.87%	4.06%	4.36%	4.86%

Source: Author

Table 1 shows that Deposit Insurance Fund Skopje has reached its target reserve level in year 2010 and has exceeded it in the following years.

The investment activity of Deposit Insurance Fund Skopje is also a source of Fund's resources. Article 22 of the Statute of Deposit Insurance Fund Skopje defines the investment activity of this institution. The interest income flow from the investment policy of the Fund has a permanent increment.

The increase of the Funds' resources has led to a permanent increase of the interest income from the investment activity of Deposit Insurance Fund Skopje. The ratio of interest income to operating expenses of the Fund has a permanent decline since the operating expenses are more or less constant for the whole observed period. This ratio is a very important indicator of the deposit insurance institution efficiency. IMF recommends (IMF, 2010) that the value of this ratio should not exceed 50%. The ratio of income to operating expenses in the deposit insurance system of Republic of Macedonia is significantly lower than the maximal limit recommended by IMF for the whole observed period, with a highest value of 28.42% in 2006 and lowest value of 5.17% in 2012. Article 23 of Fund's Statute predicts that for insurance of the households' deposits, the Fund shall charge premium from its members at a rate of up to 0.7% on annual level of the total deposits of the physical persons in each bank or saving house. Through the whole period of time analyzed in this paper Deposit Insurance Fund Skopje charges its member with a maximal deposit insurance premium rate of 0.7%. The achievement of the target level of the Fund from 2010 did not lead to a deposit insurance premium reduction.

3. COMPARATIVE ANALYSIS OF MACEDONIAN DEPOSIT INSURANCE PREMIUM RATE WITH DEPOSIT INSURANCE PREMIUM RATES OF OTHER COUNTRIES

Deposit insurance premium rates of selected countries using ex-ante funding are presented in the tables of this section. Deposit insurance premium of Republic of Macedonia will be analyzed with comparison to the data from the tables.

Table 2: Deposit Insurance Premium Rates of European Countries⁴

Country	Premium Rate	Country	Premium Rate
Bosnia and Herzegovina	1.20%	Estonia	0.20%
Montenegro	1.14%	Germany	0.20%
Slovakia	between 0.1% и 0.75%	Ireland	0.20%
Macedonia	0.70%	Lithuania	0.20%
Bulgaria	0.50%	Czech Republic	0.10%
Romania	0.50%	Spain	0.080%
Croatia	0.50%	Portugal	0.056%
Albania	0.50%	Greece	between 0.0025% and 0.05%
Finland	0.30%	Hungary	between 0.0025% and 0.05%
Sweden	0.30%	Latvia	0.05%
Serbia	0.30%	Belgium	0.0175%

Source: Author

Table 2 presents deposit insurance premium rates of selected European countries. The analysis shows that Republic of Macedonia has a higher deposit

⁴ In the countries where maximum premium rate is prescribed the maximal rate is included in the table. In the countries where an interval for premium rate movement is prescribed, the interval is included in the table. The premium rates are annual.

INVESTIGATING THE ADEQUACY OF THE MACEDONIAN DEPOSIT INSURANCE PREMIUM

insurance premium rate from all European countries excluding Montenegro and Bosnia and Herzegovina.

Table 3: Deposit Insurance Premium Rates of Selected Countries from the World

Country	Premium Rate	Country	Premium Rate
Oman	0.02%	Brazil	0.30%
Bahamas	0.05%	Bangladesh	0.50%
India	0.05%	Ecuador	0.65%
Korea	0.05%	Nigeria	0.94%
Lebanon	0.05%	Venezuela	2.00%
Jamaica	0.10%	Japan	0.0048% + 0.036%
Malta	0.10%	Canada	0.33% max
Tanzania	0.10%	Taiwan	based on three level of riskiness: 0.05%, 0.055%, and 0.06%
Kenya	0.15%	Honduras	not more than 0.25%
Shree Lanka	0.15%	Peru	from 0.45% to 1.45%
Dominican Republic	0.1875%	Marshals Islands	from 0% to 0.27%
Jordan	0.20%	Micronesia	from 0% to 0.27%
Filipinas	0.20%	USA	from 0% to 0.27%
Trinidad & Tobago	0.20%	El Salvador	from 0.1% to 0.3%
Uganda	0.20%	Argentina	from 0.36% to 0.72%

Source: Author

Data from table 3, where deposit insurance premium rates from selected countries in the world are presented, indicate that deposit insurance premium of Republic of Macedonia is among the highest on the world level as well.

Deposit insurance system of Republic of Macedonia impose higher financial burden on the financial institutions than the deposit insurance systems of most of the countries of the world does. But, maybe that burdening is justified for the purpose of

collecting enough means for depositors' reimbursement. The amount of resources that Deposit Insurance Fund Skopje should collect and maintain are predicted by law to at least 4% of the total deposits in the banks, foreign bank branches and saving houses in the Republic of Macedonia. Since the target level of the Fund is achieved from 2010, the issue of premium reduction should be considered.

4. MACEDONIAN DEPOSIT INSURANCE PREMIUM RATE ANALYSIS FROM THE ASPECT OF THE TARGET RESERVE RATIO

The amount of the resources of the Deposit Insurance Fund Skopje at the end of 2010 was 4.06% from the total insurable deposits. Since then, the Fund's resources show a permanent increase to 4.36% at the end of 2011 i.e. 4.86% at the end of 2012. Because the Fund's target level has been achieved, the deposit insurance premium rate should be set on a level that will allow maintaining of the target reserve ratio. The analysis of the probability of Macedonian deposit insurance premium correction should be based on the prediction of the future increase of the households' deposits and the future income from investment activity of the Fund. This prediction is necessary because in order of maintaining the target level, the deposit insurance premium should collect enough means to cover the future growth of the households' deposits reduced by the income from the investment activity of the Fund.

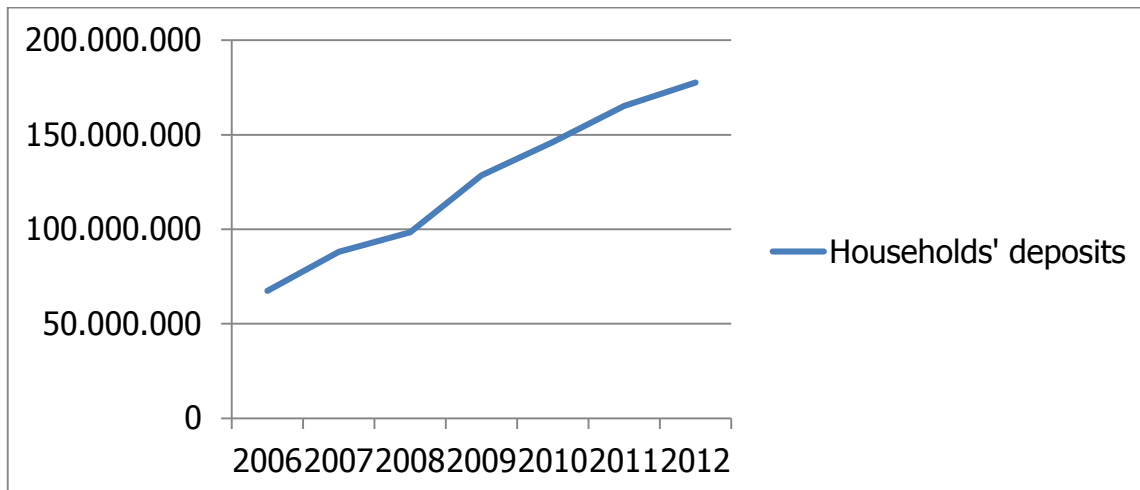
The growth of the households' deposits impose a need for collection of additional financial means, since the households' deposits are a base for target reserve ratio calculation. On the other side, one part of the income from the investment activity is used for covering the operational expenses, but the rest of it increases the fund's means. For 5-years period, since 2006 to 2012, The Deposit Insurance Fund Skopje has averagely spent 14.05%⁵ from the investment activity income for operational expenses covering. But, since as a best practice is considered 50% of the investment activity income to be used for operational expenses, when estimating the possibility for

⁵ Calculated by the author on the basis of data from the Audit reports (2006-2012) of the Deposit Insurance Fund Skopje, available at: <http://www.fodsk.org.mk/eng/report.asp>.

Macedonian deposit insurance premium collection we will assume that 50% of fund's income will be used for operational expenses covering and the other 50% for fund's means increase.⁶

Figure No 3 presents the dynamic of the households' deposits in the Republic of Macedonia for the period from 2005 to 2012.

Figure 2: Households' deposits in Republic of Macedonia (2006-2012)



Source: Summarized by the author on the basis of data from NBRM reports, available at:

<http://www.nbrm.mk/>

The figure presents a permanent increase of the households' deposits in the observed period. The average annual increase is 17.54%.⁷ Figure No 4 presents the dynamic of the income from the investment activity of the Deposit Insurance Fund Skopje for the period from 2005 to 2012. A permanent increase with an average annual rate of 32.94%⁸ has been observed. The increase of the households' deposits should be corrected with 50% from the investment activity income increase. This correction

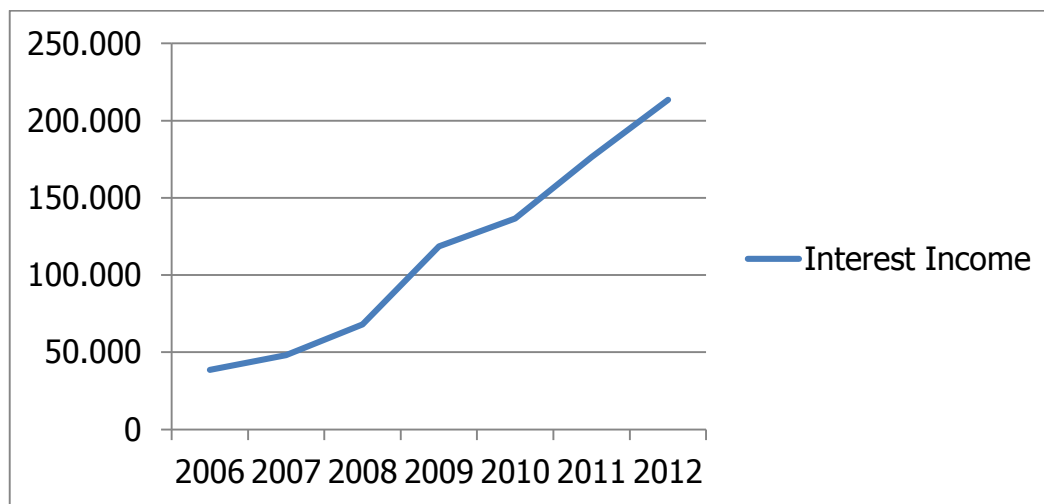
⁶ This assumption has been taken into consideration because there is possibility a need for the operational expenses increase to appear in the future. The operational expenses of the Deposit Insurance Fund Skopje may be increased in order of work efficiency improvement.

⁷ The average annual increase of the households' deposits is as follows: $\text{deposits' increase} = ((\text{deposits in 2012} / \text{deposits in 2005})^{1/(\text{number of years} - 1)} - 1)$, i.e. an average increase is calculated taking in to consideration the amounts in the first and the last year, not the variances between the years.

⁸ The average annual increase of the income from the investment activity of the Deposit Insurance Fund Skopje is calculated by the same formula as the average annual increase of the households' deposits.

should not be done on the basis of the absolute interest income increment, but on the basis of the increase of the interest income to households' deposits ratio.

Figure 3: Income from the Investment Activity of the Deposit Insurance Fund Skopje (2006-2012)



Source: Summarized by the author on the basis of data from Audit reports of the Deposit Insurance Fund Skopje, available at: <http://www.fodsk.org.mk/eng/report.asp>

When estimating the possibility of Macedonian deposit insurance premium correction we will assume that the deposit growth and the growth of the interest income to households' deposits ratio will follow the same trend as the previous observed years. The correction of the deposits growth with the investment activity income will allow us to estimate the corrected deposit base growth that will serve us as a base for deposit premium rate estimation.

When we know the value of the corrected deposit base growth, and the target reserve ratio is set to 4% of the deposits base, the deposit insurance premium rate for maintaining the target level can be calculated by the following formula:

$$\text{Deposit insurance premium rate} = \frac{4 * (\text{Corrected deposit base growth})}{100 + \text{Corrected deposit base growth}}$$

The corrected deposit base growth can be calculated as follows:

$$\text{Corrected deposit base growth} = \text{Deposit base growth} - (\text{Interest income to deposit base ratio} * (1-0.5))$$

Under assumptions of 17.54% annual growth of the households' deposits and interest income to households' deposits ratio of 0.08%, for maintaining the target reserve ratio of the deposit insurance system of the Republic of Macedonia of 4%, the deposit insurance premium rate should be 0.70%. That means that the current deposit insurance premium rate is adequate if the premium is calculated on the base of the households' deposits at the beginning of the accounting period. But, since the deposit insurance premium of Republic of Macedonia is calculated on a monthly basis this premium rate should not be considered as referent. We will consider this premium rate as maximal and the minimal premium rate will be calculated on the basis of households' deposits on the end of the accounting period. Since there are great variances in the movement of the households' deposits on a monthly basis, as a referent deposit insurance premium rate in this research we will consider the average premium rate calculated as an arithmetical mean of the maximal and the minimal premium rate. The amount of the minimal rate is 0.60%, and the amount of the average deposit insurance premium rate adequate for maintaining the target reserve ratio of the deposit insurance system of Republic of Macedonia is 0.65%.

5. CONCLUSION

The Deposit Insurance Fund Skopje charges premium from its members at a rate of 0.7% on annual level of the total deposits of the physical persons in each bank or saving house. The aim of this paper is to investigate the adequacy of this premium rate. The deposit insurance premium rate adequacy has been analyzed comparatively to premium rates of other countries in the world and from the target reserve ratio point of view.

The comparative analysis shows that the Republic of Macedonia has a higher deposit insurance premium rate from all European countries excluding Montenegro and Bosnia and Herzegovina. On the world level Macedonian deposit insurance premium rate is among the highest premium rates as well. The analysis from the target reserve ratio point of view shows that the target level of the Deposit Insurance Fund Skopje

has been achieved since 2010, so the issue of premium reduction should be considered. The premium rate should be set on a level that will allow maintaining of the achieved target reserve ratio. Because of the dynamic growth of the households' deposits maintaining the target reserve ratio of the Macedonian deposit insurance fund requires only a little lower premium rate than the regular i.e. the deposit insurance premium rate of Republic of Macedonia can be reduced to 0.65%.

Greater reduction of the premium rate should be expected when the growth of the households' deposits will be stabilized with the development of the secondary financial market. An analysis of the target reserve ratio adequacy can open a possibility for premium reduction and a future research should be conducted on this matter. Introduction of a risk-based deposit insurance premium will lead to a premium reduction of the financial institutions that will be considered as least risky and this is also a very important issue that deserves scientific attention.

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