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Barriers to cross-border trade in intermediate goods within regional value chains in the CEFTA region

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ABSTRACT

This paper investigates the barriers to the development of regional supply chains to support the growth of regional trade in the CEFTA region. The paper first identifies the way in which regional FTAs such as CEFTA may bring about structural change and tendencies to either convergence or divergence among partner economies. Tendencies to agglomeration of benefits in countries with strong manufacturing sectors are identified. In the case of CEFTA we show that Serbia (and to some extent North Macedonia and Bosnia and Herzegovina) has used its policy of subsidising FDI in the manufacturing sector by establishing a network of special economic zones (SEZs) to gain an advantage on the regional market through boosting its capacity for the production of manufactured goods for export. We argue that the tendency towards economic divergence within CEFTA that this creates could potentially be offset by developing regional value chains to supply inputs to multinational companies based in SEZs. However, there are many barriers to the development of such cross-border regional value chains. The paper presents some qualitative research findings that reveal the range of barriers to the development of regional value chains involving SMEs. It concludes with some reflections of how policy could be focused to best reduce the barriers to regional value chains, with the aim of harnessing the opportunities offered by CEFTA to reverse the process of divergence among partner economies.

1. Introduction

This paper investigates the barriers to the development of regional value chains that would leverage foreign investment to support the growth of regional trade through regional supply chains. Specifically, we are interested in the development of regional value chains to supply inputs to multinational companies located in special economic zones (SEZs) that have been established in the region.

Recently, the inflow of foreign direct investment (FDI) into the manufacturing sectors in the CEFTA partners has begun to pick up. Much of it has been attracted into sectors related to the motorcar components industry linked to global value chains (GVCs) and international production networks (IPNs) mainly through inward processing of intermediate goods (Shimbov et al., 2016). As a result, the region is gradually becoming integrated into GVCs/IPNs in manufacturing industry. Analysis of industrial production by industrial sectors shows a structure of production consisting mainly of the production of parts and components for final products and raw materials (Shimbov et al., 2013). For example, in Bosnia and Herzegovina, final export products are mainly components and sub-components for the production of machinery and electrical equipment. In Serbia, some final products are assembled and exported as vehicles, but most inputs and equipment are imported, and many export products are components and sub-components or raw materials. In the growing IT and business service sectors, many local companies from the region work for foreign partners as outsourcing suppliers. Such intermediate goods have been an important driver of export growth in CEFTA economies (OECD, 2013) and in the upgrading of their technology level (Shimbov et al., 2019). CEFTA partners have provided incentives to attract such investment, although as yet not in the coordinated manner envisaged by the Berlin Process sponsored “Regional Investment Reform Agenda” (RCC, 2018; RCC & CEFTA, 2018).

The paper is set out as follows. In **section 2** we identify the way in which regional FTAs such as CEFTA may bring about structural change and tendencies to convergence or divergence among partner economies, focusing on trade effects, scale and competition effects and location effects. In **section 3** we set out some empirical evidence on the divergence in export performance of CEFTA partners. In **section 4** we explore the role of industrial policy, and in particular the policy around investment attraction, in driving the trends to divergence in the region. We focus on the role of SEZs in attracting new manufacturing FDI to CEFTA members where the policy of investment attraction through high levels of state aid based on employment and investment subsidies to multinational companies (MNCs) has been pursued most aggressively. We consider the potential for spillover effects into the local economy and show that these have as yet been minimal. In **section 5** we explore the potential for the development of regional value chains that could potentially offset the tendencies to regional divergence among CEFTA partners. We identify the barriers to the development of such cross-border regional value chains. In **section 6** we set out our conclusions, identifying where policy could be

focused to reduce the barriers to regional value chains, with the aim of developing the regional supply capacity of SMEs in manufacturing industry.

2. Divergence tendencies in regional FTAs

Economic theory suggests that there may be both positive and negative effects of regional free trade agreements. The positive effects can be divided into scale and competition effects on the one hand and trade and location effects on the other hand. However, trade and location effects can also produce a negative impact on parties to a free trade agreement (through trade diversion and geographic polarisation). The interplay of these factors may lead to the economic divergence of the countries concerned.

2.1. *Trade effects*

The purpose of a free trade agreement is to increase trade flows between the partner economies. A reduction of tariffs is expected to create new trade flows since the price of traded goods will fall. However, trade integration within a free trade area may also lead to trade diversion. Just as trade is created between partners, so trade may be diverted from third countries. Companies based in the free trade area may gain from being able to purchase inputs more cheaply from within the free trade area, switching their purchases away from third countries to economies within the free trade area, but the government may suffer due to a loss of tariff revenues. In such a case the introduction of a free trade area may reduce welfare rather than increase it. Trade diversion is less likely to be a problem if the economy has a low external tariff towards third countries, or similar tariff structures towards third countries. This is the case in relation to trade between the Western Balkan economies and the EU since under the Stabilisation and Association Agreements (SAA) the Western Balkan economies are implementing free trade policies towards the EU and have or are in the process of eliminating their tariffs on trade with the EU. However, the recent imposition of tariffs by Kosovo* on the imports from Bosnia and Herzegovina and Serbia shows that the loss of tariff revenues can be a serious problem for small economies within a free trade area that are also losing out on inflows of FDI and suffering the effects of regional agglomeration of manufacturing activities in the stronger part (see next subsection).

2.2. *Scale and competition effects*

Scale and competition effects are linked to the creation of a larger market. Greater competition from imports undermines the restrictive practices of monopolistic firms operating in small national markets and may therefore increase the efficiency of previously protected producers (Collier et al., 2000). In a free trade area, economies of scale can reduce the costs of production and lead to improvements in competitiveness. Empirical research has identified these effects in a number of studies. Roberts and

* This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

Tybout (1996) provided an early demonstration of these effects by showing a relationship between liberalisation and efficiency. In practice, many of the potential benefits of trade opening through reductions in tariffs, quotas and duties are likely to remain unrealised as long as non-tariff barriers to trade persist. The removal of non-tariff barriers requires the introduction of complementary measures to accompany the basic policy of trade liberalisation, including measures such as harmonisation of laws, standards, licensing arrangements as well as the removal of the pervasive corruption that hinders trade in the region. Measures such as these require what is known as deep integration, which in turn depends upon much more extensive political cooperation and policy coordination than what exists at the current time in the region. This is arguably the aim of the Berlin process initiative to establish a Regional Economic Area in the Western Balkans.

2.3. Location effects: convergence and divergence

Even if the overall effects of trade liberalisation and economic cooperation and integration are beneficial, there remains the question of the distribution of those gains between the members of the regional trade agreement. If economic convergence takes place in terms of economic growth rates and levels of GDP per capita, then the process is beneficial to all partners and likely to be sustainable. If the opposite occurs and economic divergence takes place, then the regional cooperation policies are unlikely to be sustained in the long run.

Orthodox neoclassical economic theory suggests that regional convergence is likely to be the outcome of trade liberalisation arrangements. This is because any differences in relative factor prices are likely to be reflected in trade flows. Poorer economies in the regional cooperation partnership will have a comparative advantage in exporting labour intensive goods, and so an increase in their exports will create jobs and reduce unemployment, leading to a process of regional convergence.

On the other hand, there may be offsetting forces at work leading in the direction of regional divergence. An example may be as follows. After the implementation of a free trade agreement, manufacturing companies based in Serbia may increase their sales on both Serbian and Kosovan markets as trade is diverted away from countries that previously supplied the Kosovan market in favour of Serbia. In this case, Serbia would benefit more from the free trade agreement than would Kosovo*. The impact of this is likely to be less if external tariffs in both economies are relatively low in respect to third countries.

A second and more problematic mechanism through which trends towards regional divergence can occur is through the process of geographical “agglomeration”. Agglomeration occurs when industries have an incentive to cluster together in a particular location (Krugman, 1991). The factors which may bring this about include increasing returns to scale, knowledge spill-overs, technical external effects between firms located close to each other, labour market pooling such that firms can benefit from locally available supply of skilled labour, and backward (demand) and forward (supply) linkages which create interdependencies between the location decisions of firms. If such agglomeration effects are

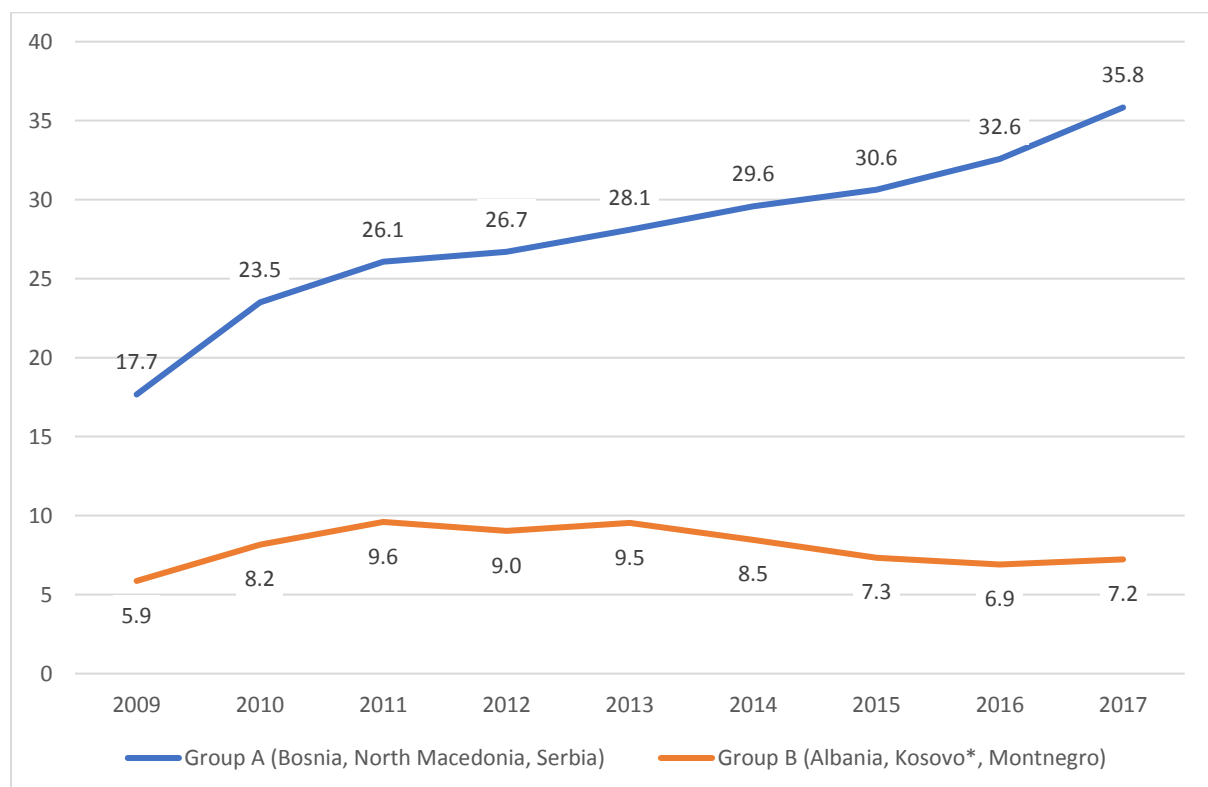
sufficiently strong, so that – in our example – clustering advantages bring about the concentration of manufacturing activities in Serbia and the de-industrialisation of Kosovo*, then free trade agreements will have a perverse inequalising effect. Regional divergence rather than regional convergence may be the net outcome.

Divergence of production and income levels may threaten group cohesion and undermine the political will for regional cooperation. This is possibly part of the explanation for the growth of tensions that has recently been observed between Serbia and Kosovo*, for example.

3. Empirical evidence on divergence between CEFTA economies

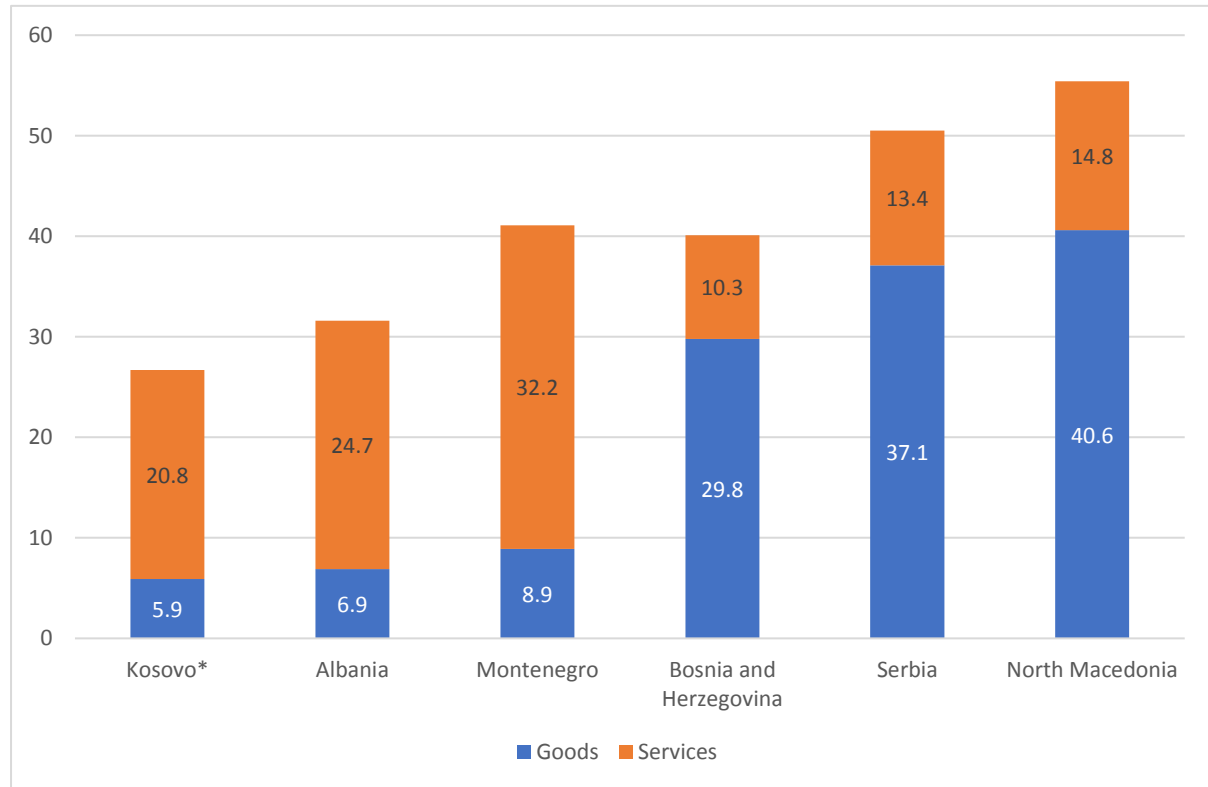
In this section evidence is presented on the evolution of manufacturing goods trade in the CEFTA partners showing that Serbia has gained most in the form of an increase in manufacturing exports while Albania, Kosovo* and Montenegro have remained de-industrialised and reliant mainly upon services exports. It will be shown that CEFTA free trade arrangements, along with the generous subsidies provided by Serbia to attract FDI in the manufacturing sector in SEZs has led to forces of agglomeration which have concentrated the benefits of CEFTA in the Serbian manufacturing industry expansion, while other CEFTA partners have been left behind and a process of divergence between the economies has taken place. One solution to this divergence is the creation of regional supply chains to create spill over effects from the Serbian SEZs to other partner economies in the region.

Figure 1: Exports of goods by country group (% GDP)



Observation of the sectoral export patterns of the economies of the Western Balkans reveals that three of the economies specialise in manufacturing activities (Bosnia and Herzegovina, North Macedonia and Serbia) while the other three economies specialise in the export of services (Albania, Kosovo* and Montenegro) (see Figures 1 and 2).

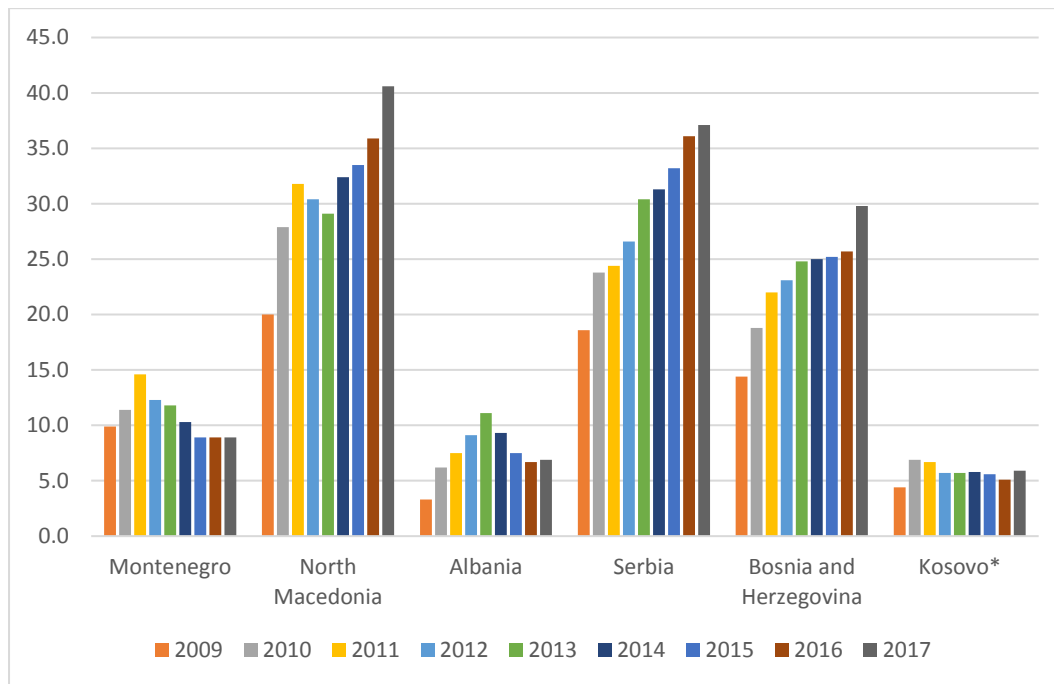
Figure 2: Shares of goods and services exports in GDP, 2017 (% GDP)



Source: Eurostat online data [nama_10_gdp]

Moreover, this specialisation pattern has been evolving over time. Albania, Kosovo* and Montenegro have experienced stagnation in the share of their goods exports in GDP over the period from 2009 to 2017. In contrast the other three economies (Bosnia and Herzegovina, North Macedonia and Serbia) have seen a rapid growth in the share of goods exports in GDP (see Figure 3). The effect has been particularly strong in the cases of North Macedonia and Serbia.

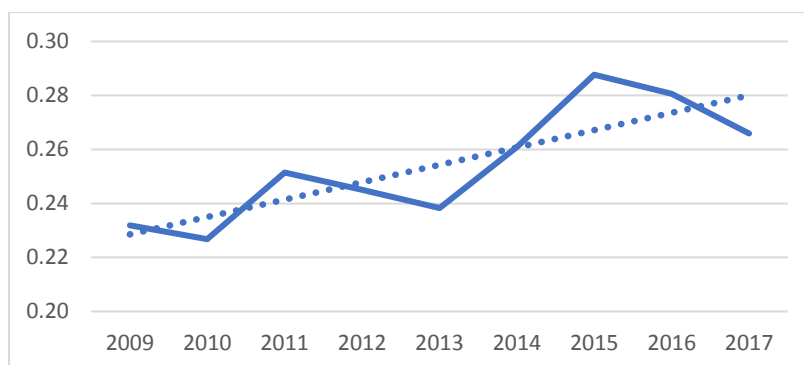
Figure 3: Growth of goods exports in Western Balkan economies, share of goods exports in GDP (%) 2009-2017



Source: Eurostat online data [nama_10_gdp]

The overall outcome has been a tend towards divergence of the economies in the region. In Figure 4 the evolution of the coefficient of variation in the share of goods exports in GDP of the six economies is shown. This reveals a clear pattern of divergence over time, during the period in which the CEFTA agreement has been in effect.

Figure 4: Coefficient of variation of share of goods exports in GDP



Source: Eurostat online data [nama_10_gdp]

4. Attracting manufacturing FDI as an industrial policy

In addition to the inequalising effects of the CEFTA free trade agreement through agglomeration due to trade, the industrial policy in the Bosnia and Herzegovina, North Macedonia and Serbia have involved measures to attract foreign direct investment (FDI) in the manufacturing sector. These policies have involved a range of subsidies to multinational corporations, which have generated a remarkable increase in FDI in recent years, especially to Serbia. In addition to general subsidies, the policies have in particular led to the establishment of special economic zones (SEZs) in these economies (Bartlett et al. 2019). In the SEZs companies enjoy a wide range of benefits ranging from 0% VAT, 0% customs duties and 0% profit taxes and other subsidies. More generally, industrial policies have been based on low corporate profit taxes rates and investment and employment subsidies. These policies have been used to aggressively attract multinational companies involved in the export sector.

4.1. The role of special economic zones as an investment attraction policy

Special Economic Zones (SEZs) in the Western Balkans have mainly been established as export processing zones within duty-free areas that provide infrastructure and facilities for manufacturing activities aimed at export markets. SEZs go by different names and obtain different forms in each of the WB economies (see Table 1). A prominent example is the SEZ in Kragujevac in Serbia, which was established to support the Italian car-maker Fiat to regenerate the derelict Zastava car plant in Kragujevac. SEZs are called “Free Zones” in Serbia and “Technological Industrial Development Zones” in North Macedonia. The establishment of SEZs in these two countries has enabled foreign companies to sidestep the difficulties of dealing with poor infrastructure and unwieldy bureaucracies in the domestic markets and has become an important tool for attracting FDI.

Table 1: Different forms of SEZ in Western Balkan economies

Country	Name of EPZ
Albania	“Technology and Economic Development Areas” (none active)
Bosnia	“Free Zones” (4 active EPZs)
Kosovo*	“Industrial Zones” (no EPZs)
Macedonia	“Technological Industrial Development Zones (8 active EPZs)
Montenegro	“Strategic Business Zones” (5 EPZs planned)
Serbia	“Free Zones” (14 active EPZs)

Source: Bartlett et al. (2017)

The institutional design of SEZs is based either on a centralised or a decentralised approach. In the former, SEZs are planned and financed by a central government agency, and in the latter local authorities create them within a legal framework set by the central government. The centralised

approach focuses on the coordination of infrastructure, while the decentralised approach may better meet the needs of local communities and local business actors (Mohberg, 2015).

Serbia has adopted a decentralised design for SEZs. Local municipalities are empowered to establish a SEZ subject to authorisation by the Free Zone Administration. Municipal ownership ensures that local interests are taken into account.² Altogether, 14 SEZs have been established in Serbia and 221 companies were located in them in 2017.³ Raw materials and equipment imported into a SEZ, and production carried out within it, are free of customs duties and VAT. Construction materials, transport services and energy (electricity, gas, oil, coal) can be purchased free of VAT by SEZ-based companies. The Serbian Development Agency (RAS) provides investment subsidies to foreign investors located either inside or outside SEZs depending on the level of municipal development, investment size, and the number of jobs created. The programme was set out in the Investment Law, supplemented by the Decree on Terms and Conditions for Attracting Direct Investments (Government of Serbia, 2016). While the law is equally applicable to domestic and foreign companies, the aim is to attract foreign investors, and beneficiaries should be involved in international trade. Investors that have negotiated agreements with RAS received an average subsidy of EUR9,000 per job created in 2014, EUR7,000 in 2015, and EUR5,000 in 2016.⁴ These subsidies are equivalent to about half of the total investment per employee in SEZs.

In contrast, a centralised design has been adopted in North Macedonia where SEZs are under central state ownership. The Directorate for Technology Industrial Development Zones (DTIDZ) establishes and develops the SEZs and monitors and regulates users' activities. It also has responsibility for investment promotion in the SEZs, negotiating incentive contracts with prospective investors on behalf of the government and providing aftercare services for SEZ-based investors. Eight active SEZs that host 18 foreign companies have been established. Subsidies to attract high-tech FDI companies include 0% customs duties or VAT on imported goods or equipment (vs. the standard 18%); 0% profit tax for up to ten years (vs. the standard 10%); subsidies to build a factory up to EUR500,000; employment subsidies up to 50 percent of the gross wage; and 50 percent of justified investment costs up to EUR50 million.

In Bosnia and Herzegovina, a decentralised approach has been adopted, but the law has not been effectively implemented and SEZ-based companies in practice do not receive subsidies so that the number of companies based in the four SEZs has stagnated. The other three economies do not have an effective SEZ policy or policy to attract FDI.

Investment in SEZs in the Western Balkans has been especially significant in the motorcar components industry (Shimbov, Alguacil, & Suárez, 2016). In Serbia, for example, the largest exports are finished

² Ownership by municipalities is not universal; the SEZ in Kragujevac is owned by the Fiat motor company.

³ Data from annual reports of the Free Zone Administration in Belgrade, available on the website of the Serbian Ministry of Finance: <http://www.usz.gov.rs/eng/index.php>

⁴ Interview with RAS – Serbian Development Agency, March 2017.

motorcars from SEZ Kragujevac, while other SEZs produce motorcar components including electrical motors, tyres, and other parts and accessories for motorcars. A relatively small part of SEZ exports consist of metal products, shoes, furniture, and plastic products. The focus on motorcar components reflects the integration of Serbian SEZs into the EU and global value chains in this sector. Most SEZs specialise in the production of one or a few export products (see Table 2).

Table 2: Shares of Main Export Products in Each SEZ's Total Exports, Serbia (in %)

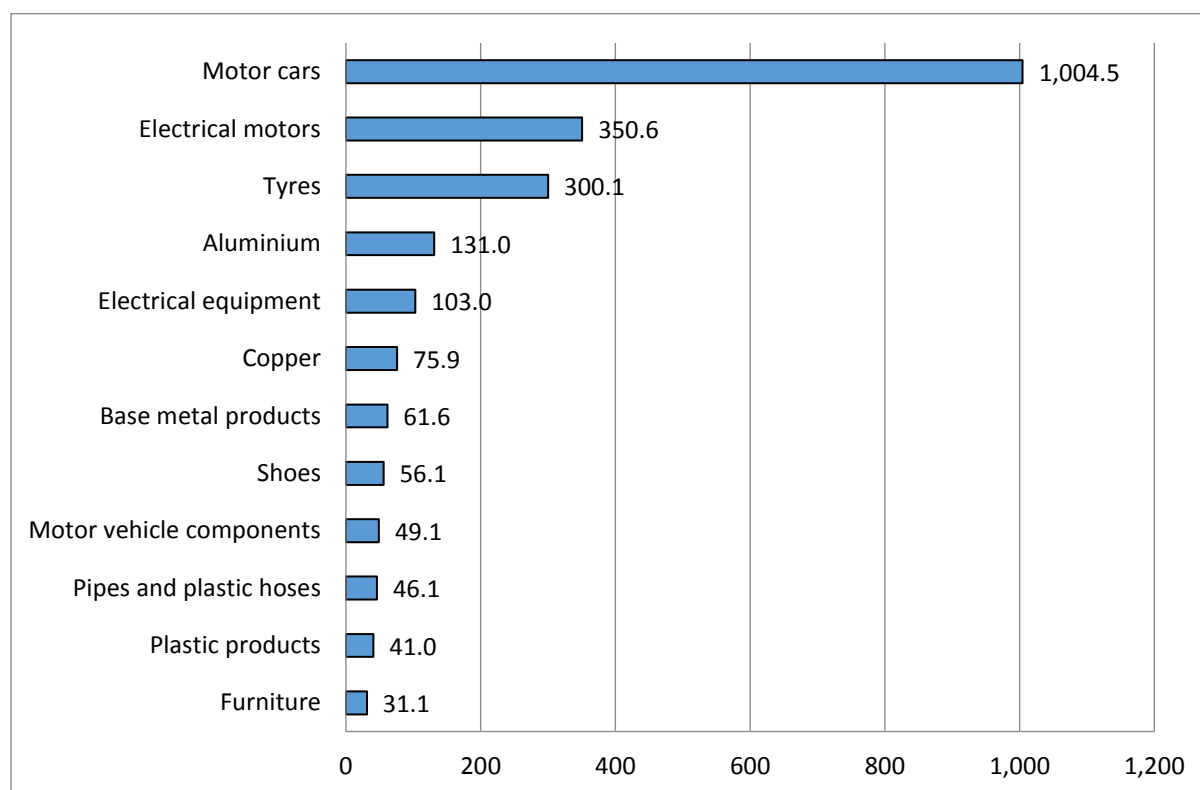
SEZ location	2012	2013	2014	2015	2016	Exported products
Apatin	85.1	81.5	79.4	78.5	72.6	Alcoholic drinks, corn and beans, oil seeds; shoes and knitted fabrics
Beograd	43.5	54.2	57.4	50.9	45.0	Edible products, medicines and cosmetics
Kragujevac	93.1	94.7	91.9	91.4	91.6	Automobiles
Kruševac	--	--	96.2	90.0	100.0	Inorganic chemicals, synthetic rubber, regenerated rubber, waste and tyres for automobiles
Novi Sad	0.0	18.9	28.2	55.7	70.0	Petroleum products
Pirot	94.1	94.6	94.4	95.6	95.0	Tyres for automobiles
Šabac	--	--	96.6	94.7	69.7	Nails and screws
Smederevo			20.0	41.6	57.0	Electrical equipment
Subotica	89.1	83.8	70.4	65.5	71.0	Electrical motors
Užice	99.3	97.2	97.1	97.0	96.5	Aluminium and copper
Vranje	46.7	41.3	34.6	33.4	42.7	Furniture and shoes
Zrenjanin	0.0	92.0	92.2	91.8	88.1	Electrical equipment

Source: Statistical Office of the Republic of Serbia (authors' calculations).

The high degree of specialisation is observable as only three product groups account for about two-thirds of exports from all SEZs in Serbia: motorcars (produced at Kragujevac), tyres (produced at Pirot) and electrical motors (produced at Subotica).⁵ This specialisation of production in relatively few product groups (see Figure 5) demonstrates the close integration of the SEZs into the EU and global value chains. This has played an important role in the revival of Serbia's exports and in the country's achievement in raising the share of goods exports in GDP to 35% in 2015, above the EU average of 32% of GDP.

⁵ While the production of motorcars has been falling since 2013, due to a lack of new investment in the production line and in the development of a new model, the gap has been partly made up by an increase in the production of tyres and electrical motors.

Figure 5: Exports from Serbian SEZs (Free Zones) by product group, 2016 (€ millions)



Source: Statistical Office of the Republic of Serbia

Exports from SEZs have formed a substantial part of the Serbian economy's export boom in recent years, accounting for 13.3% of total exports in 2017.⁶ Exports per employee were substantially higher than in the manufacturing industry as a whole, reflecting the aim of the SEZ policy to contribute to the export-led growth of the Serbian economy (see Table 3). Nevertheless, exports per employee have stagnated in the SEZs reflecting the overall absence of labour productivity growth (Bartlett et al. 2019), possibly due to the perverse incentives effects of the employment subsidies offered to foreign investors.

⁶ Total exports from Serbian SEZs increased from EUR2,164 million in 2013 to EUR2,262.2 million in 2017, while imports decreased from EUR2,242 million to EUR2,180 million.

Table 3 International Trade of Serbian SEZs and Manufacturing Industry (2013-2017)

		2013	2014	2015	2016	2017
Exports per employee (EUR)	SEZs	79,656	85,567	75,350	87,679	79,752
	Manufacturing sector	31,419	33,519	35,580	37,987	40,113
Exports/GVA	SEZs	67.3%	66.3%	71.1%	82.2%	82.6%
	Manufacturing sector	50.3%	52.8%	54.5%	45.3%	58.9%

Sources: Free Zone Administration Annual Reports, authors' calculations and Statistical Office of the Republic of Serbia. Notes: GVA = gross value added.

The main aim of the Serbian SEZ policy has been to boost the competitiveness of exports. This seems to be successful, as the share of exports in GVA in SEZs averaged 73.9% over the period from 2013 to 2017, compared to just 50.4% for manufacturing industry as a whole. Moreover, this indicator increased by 15.3 percentage points in the SEZs over this period compared to just 8.6 percentage points for the whole of manufacturing industry. The relatively low share of exports in GVA in the early years of the SEZ experience suggests that a relatively large component of value added may have been related to the construction of factories within the SEZs or to sales on the domestic market.

Overall, the evidence suggests that industrial policy in Serbia especially, and also in North Macedonia and to some extent in Bosnia and Herzegovina, has led to an increase in manufacturing output based on a policy of using subsidies to attract multinational companies in the manufacturing sector. This has led to the development of new manufacturing centres in these economies which has attracted the bulk of manufacturing investment in the region, leaving other economies that have not adopted such policies behind. This agglomeration of activity has also been an effect of the CEFTA agreement which has enabled investors to locate in the economies with larger investment subsidies and sell their products throughout the whole region, in addition to exporting to the EU.

5. Spillover effects and backward linkages

A substantial body of research has investigated the spillover effects of manufacturing FDI in transition economies. The aim has been to identify how foreign MNC activities have affected the performance and productivity of domestic firms. Such spillovers can take place through both horizontal and vertical linkages. Horizontal spillovers refer to MNC effects on domestic producers in the same industry. Vertical spillovers relate to MNC effects on supplying firms.⁷ It is the latter type of spillover that concerns us here, which the literature has called “backward” vertical spillovers, and the effects that such linkages between MNCs and their domestic suppliers works through a variety of channels beyond

⁷ Vertical linkages with supplying firms are known as “backward” spillovers, vertical linkages with firms that purchase goods or services from MNCs are known as “forward” spillovers.

the straightforward business and employment benefits of supplying goods and services to an MNC, whether located in a SEZ or outside it.⁸ One of the additional channels through which backward linkages occurs is through the supply of technology by MNCs to their domestic suppliers which may improve their productivity and the quality of goods and services they supply. Another is when an increase in orders from an MNC for component supplies from a domestic firm increases the demand for its products, allowing it to benefit from cost reductions due to greater economies of scale.

General evidence on the existence of backward spillovers in transition countries is mixed.

5.1. Evidence of backward spillovers in CESEE

A considerable amount of research has been carried out on the existence of backward spillovers in the Central and South East European (CESEE) transition economies. An early study by Schoors and Van der Tol (2002) found evidence of positive backward spillovers from foreign MNCs to domestic Hungarian companies, and Javorcik (2004) found similar evidence for Lithuania. There is some evidence that positive spillovers in the form of knowledge transfers is limited to better performing suppliers in high-technology industries (Gersl et al., 2017; Javorcik and Spataraneu, 2008). Domanski and Gwosdz (2009), Jurgens and Krzywdzinski (2009) and Gentile-Ludecke and Giroud (2011) all identify that the presence of foreign MNCs in Central Europe has led to an upgrading of the domestic component supply industry. Gorodnichenko et al. (2014) analysed an enterprise survey covering 17 transition countries and found strong evidence of positive backward spillovers to domestically owned firms.

In contrast, some researchers have been more sceptical about the extent of backward spillovers from foreign MNCs to domestic firms. Ayyagari and Kosova (2010) found no evidence of backward spillovers in the Czech motor industry. Rugraff (2013) also studied backward linkages in the Czech motorcar industry, principally related to the linkages with Volkswagen-Skoda. He found that domestic suppliers contribute little to the sales of components to foreign MNCs, and that most domestically sourced inputs came from “follow-source” suppliers that are foreign-owned affiliates, themselves belonging to global MNCs. These examples are relevant for the CEFTA countries where the motorcar industry has been a principal sector for FDI in recent years. The finding about the role of follow-source suppliers is an important warning about the obstacles to generating backward spillovers to domestic components suppliers. For example, in the SEZ in Kragujevac where FIAT has a large factory producing motorcars, foreign component-producing follow-source suppliers have entered the SEZ to become the major component suppliers to FIAT, thus limiting the potential for domestic SMEs to become engaged in supplying components to the factory.

⁸ For detailed evidence of intra-industry (horizontal) spillovers in the WB region and how these vary by the origin of investors, comparatively to other regions in the European periphery, see Monastiriotis (2016).

Upgrading & technology transfer & quality standards

As explained above a main focus of researchers in the field has been the potential for technology and knowledge spillovers from foreign-owned MNCs to component suppliers in the domestic supply chain. MNCs often transfer technology to domestic component suppliers in order to increase the quality of the inputs they receive (Pack and Saggi, 2001). Javorcik (2004) found that in Lithuania, MNCs have a strong interest in upgrading their supplier base to improve the quality of locally purchased inputs. Such technology transfer has also been observed in Hungary (Schoors and Van der Tol, 2001) and the Czech Republic (Stancik, 2007). The role of quality standards also has a role to play in upgrading the supply chain. For example, Gorodnichenko et al. (2014) found that when foreign firms demand higher standards, they incentivise domestic suppliers to improve their quality of their production and services.

Limited absorptive capacity

Several researchers have argued that the capacity of domestic firms to benefit from backward spillovers is often limited (Blalock and Gertler, 2009; Nicolini and Resmini, 2010; Damijan et al., 2013).⁹ A lack of absorptive capacity of domestic firms may hinder the contribution of MNCs to local economic development. Often domestic firms lack the quality standards, the sale of production and the connective networks that would enable them to take advantage of the opportunities available to integrate into regional and global value chains in which foreign MNCs especially those located in SEZs are embedded. This phenomenon appears to be widespread. In a study of Polish firms, Marcin (2008) found that the absorptive capacity of local firms places a limit on the size of spillovers. Gorodnichenko et al. (2014) also found that the limited absorptive capacity of domestic firms can be a barrier to backward spillovers.¹⁰ This factor suggests the need for a more proactive role of central and local governments in building the supply capacity of local SMEs to engage in supply chain relationships with the MNC manufacturers, inside or outside SEZs, in the CEFTA region.

Character of MNCs and their relationships with suppliers

The extent of backward spillover may also depend on the characteristics of the MNCs involved. Determining factors have been found to include whether the ownership structure involves a joint-venture with a domestic company (Javorcik and Spataraneu, 2008) (in the case of Romania) and the degree of export orientation (Sgard, 2001). The nature of the relationship between MNCs and domestic component suppliers is also important. Long-term contractual relationships between the two are more likely to generate positive spillover effects compared to short term contracts. Suppliers based in locations where there is an agglomeration of MNCs, such as close to SEZs or in large cities,

⁹ The extent and quality of such backward linkages may also depend more generally on the characteristics of the host economy (Crespo and Fontoura, 2007).

¹⁰ Here, absorptive capacity is designed as the distance of the technology used by the firm in question from the "efficiency frontier" defined by the best-performing firms.

may also reap a benefit of repeated relationships over a long period of time. Such relationships can build trust between MNCs and their suppliers, and foster positive backward spillovers (Dyer and Singh, 1998).

5.2. Backward spillovers in the CEFTA region

Investments by multinational companies in SEZs in the CEFTA region have provided few linkages to the local economy and have done little to develop intra-regional trade (Bartlett et al., 2019). This is related to the high import intensity of production in SEZs which reported an import/export ratio of 96.8% in 2017.¹¹ An example in practice is the case of the Belgian company Metech based at the SEZ in Smederevo, which imported, in 2017, 80% of its raw materials from Belgium and exported 95% of the final product back to Belgium to the parent company Metes. With such a high overall import intensity of production, it is unlikely that there is much indirect spill-over to the local economy through backward linkages to local suppliers. Most of the effect is likely to come from direct employment, much of which, as explained above, is subsidised by the state through the employment subsidy scheme managed by the RAS. It could be questioned whether this model of attracting FDI is likely to be a strong driver of economic growth and development in the future. The import intensity of the Serbian manufacturing sector is lower than in SEZs, but is nevertheless very high, indicating that this is a general problem not confined to SEZs, but also reflecting the import intensity of subsidised foreign investors based outside the SEZs.

Table 4: Percentage of your domestic sales made to multinationals located in seller's economy (% of total inputs)

	Albania	Bosnia	Kosovo*	Montenegro	North Macedonia	Serbia	All economies
2015	2.0	7.0	3.0	6.0	0.0	4.0	3.7
2016	1.5	6.4	4.1	6.9	3.4	5.1	4.6
2017	2.0	3.0	14.0	5.0	3.0	7.0	5.7
2018	2.0	4.0	4.0	3.0	2.0	5.0	3.3
2019	4.0	7.0	9.0	3.0	4.0	9.0	6.0
All years	2.3	5.5	6.8	4.8	2.5	6.0	4.6

Source: RCC Balkan Barometer online data

Data on the sales by domestic firms to MNCs based in their country are available from the Balkan Business Barometer survey implemented over a number of years by the Regional Cooperation Council. These surveys show that only a small proportion of sales of domestic companies are made to foreign MNCs based in their country. Over the five years of the survey, the highest proportion of sales made by domestic firms to foreign MNCs was in Kosovo* and Serbia, while the average for all economies over all five years was just 4.6% of sales (see Table 4). This suggests that the backward spillovers in

¹¹ Free Zone Administration Annual Reports, authors' calculations.

terms of business generated in the domestic economy by foreign MNCs is extremely limited. Given this, it is likely that all other forms of backward linkages are also small.

This finding is supported by the results of field research carried out by the authors in Serbia and North Macedonia in 2017. Even where foreign investors would like to source their inputs locally, there are many barriers to doing so ranging from technology gaps, a lack of subsidies for local SMEs supplying inputs, and non-tariff barriers to the provision of intra-regional services (Bartlett et al., 2019). Insights from the qualitative interviews suggest that there is little engagement of local suppliers to SEZ value chains. As the manager of one SEZ-based MNC reported to us “the involvement of the local suppliers is very restricted as they only get involved in construction and provision of services. The integration of local suppliers into supply chains is limited”.¹² In Serbia, multinational companies located in SEZs mainly import intermediate products. Some local sourcing takes place, but mostly in services (transport, packaging, catering, etc). At the same time companies in the CEFTA region are suppliers of intermediate products to EU and global companies, and importers of intermediate products from EU and global markets. These internationalised local companies show that there is capacity to meet the requirements of MNCs, for example in delivering customized small series of components in the metal industry. At the same time “Large corporations simply don’t want to negotiate or contact with many SMEs individually, there should be one representative for group of SMEs to present a potential offer for specific products or services with precise technical specifications. But SMEs are not grouping together and coming with a single representative”.¹³ Local suppliers are not engaged, except for some indirect services unrelated to production inputs. SEZ-based companies are interested in cooperation and they actively look for local suppliers, but local suppliers do not meet the requirements in terms of quality, technology, standards and prices. For example, Siemens launched a call for 100 suppliers in the CEFTA region, and only 14 firms satisfied the basic qualification criteria. Local suppliers are also not organized and do not cooperate with each other. Siemens would prefer to negotiate with one representative, not with each SME individually.

SEZ-based MNCs mainly use local suppliers for construction work in building a factory, for maintenance services, and for transportation. According to one interviewee, SEZ-based companies are mainly interested in using local suppliers due to the cheaper prices, closer location which reduces transport costs, ease of access to maintenance services. However, even for these service inputs the supply is still insufficient in amount and quality.¹⁴

¹² Interview with General Director, Normak Investment Group, Tetovo, North Macedonia, February 2017.

¹³ Interview with Serbian Regional Chamber of Commerce, March 2017

¹⁴ Interview with Plant Manager, ADIENT, North Macedonia, February 2017.

Box 1: Findings from Field interviews with SEZs' company managers

Use local inputs (materials and labour) and cooperation of WB value chains

- Use almost entire workforce locally, with very few exceptions for higher managerial positions
- SEZs companies use purchasing outside the WB because it is difficult to find adequate inputs
- Reliability, price stability and quality standards remain the biggest concern for increasing use of local supply base in WB
- Cooperation initiatives between SEZs companies and local suppliers usually start with small projects and gradually increasing progressively
- In one case (in North Macedonia) the company has been able to become part of the global value chain of the FDI company in SEZs
- Limited supply – there is a need for cooperation between WB6 companies in certain sectors
- Possibility of cooperation in ICT, textile, and auto-moto industry

Sources: Interviews conducted in 2017 by authors through project "Study of Special Economic Zones (SEZs) in the Western Balkans" funded by European Commission DG NEAR

The greatest linkage with the local economy is in the employment of labour. Some SEZ-based companies find that there is a need for more qualified labour and include training in their human resource strategies. Some SEZ-based companies provide work-based training in their companies. In the SEZ in Kragujevac, for example, FIAT has established its own training centre. In North Macedonia, Van Hool, based in the "Skopje 2" SEZ has contracted a training company to deliver training courses to its welding professionals. Other SEZ-based companies send their employees abroad for training. The company "Kemet" in North Macedonia regularly sends its workers abroad for six-month training courses in Germany, Italy and the UK. In Smederevo in Serbia, the "Rosa Catena" company that produces chains from steel plate sends its operators to Italy for training.

Other companies have developed cooperative links with local vocational schools to modernise the curricula and ensure a steady supply of appropriately skilled workers to meet future demand. In North Macedonia, "Kemet" has signed a Memorandum of Understanding with a school in the Ilinden municipality to create a study programme in ICT, electronics and automotive technologies. SEZ-based MNCs in Stip cooperate with the School of Electro-Technical Engineering. Van Hool collaborates with local vocational schools to deliver part of a study programme on company premises and has launched a programme for adult education to improve the skills of local workers. In Subotica, Serbia, the VET school "Ivan Sarić" has signed contracts with SEZ-based MNCs to introduce a "dual" system of vocational education.

SEZ-based companies have also begun to develop cooperative links with universities. In North Macedonia, a company in the SEZ “Skopje 1” has developed strong cooperative links with the University of Ss Cyril and Methodius in electro-mechanics and engineering. Van Hool offers scholarships for engineering students at a local university. In the SEZ in Stip, the local supplier company, Aktiva, cooperates with the local Textile University. In Serbia, FIAT cooperates with the University of Kragujevac, providing work-based learning opportunities for students and jobs for graduates. In the SEZ in Pirot, companies cooperate with universities in Belgrade, Niš, and even in Sofia in Bulgaria.

Another driver of increased productivity among supplier companies is the imposition of quality standards by foreign MNCs in SEZs. In our field research interviews, SEZ managers pointed out that reliability, price stability and quality standards remain the biggest concern for increasing use of local supply base for SEZs companies in Western Balkans (see Box 1). Suppliers have to follow standards, Tigar Tyres dictates conditions, standards, innovations (Tigar is third biggest exporter in Serbia).¹⁵ Products and services that are supplied to Tigar Tyres pass through quality control every six months.¹⁶ The service company supplier Energomont must follow the standards and requirements set by Siemens.¹⁷ The SEZ-based company Dunkermotoren would like to find local suppliers, but told us that the local SMEs do not have the required quality level, technologies nor standards in order to become suppliers.¹⁸

Apart from these backward linkages to transfer knowledge to the local labour force, there is far less effort to develop backward linkages through technology transfer. SEZ managers indicated that there is little cooperation between CEFTA-region companies especially in certain sectors to increase the capacities of the suppliers to meet demand of the multinationals located in the SEZs. However, there are a few isolated examples of successful cooperation and technology transfer between SEZ-based MNCs and domestic suppliers as Box 2 illustrates.

¹⁵ Interview with Head of Local Economic Development Office, Municipality of Pirot, March 2017

¹⁶ Interview with assistant executive director of Pirot Free Zone Management Company, Pirot, March 2017,

¹⁷ Interview with Director, Free Zone Subotica, March 2017

¹⁸ Interview with Senior Manager, Regional Development Agency Panonreg, Subotica, March 2017

Box 2: A successful example of technology transfer between SEZ-based MNC and its domestic suppliers in North Macedonia

Van Hool, an MNC based in "Skopje 2" SEZ

Van Hool is a Belgian bus manufacturer. It obtains almost all its inputs from suppliers in Spain, Germany, Rumania and Turkey. The local supply is limited to providing transport services, food, and gas supplies and less in the provision of raw materials and other inputs necessary for the production process. This is because of the limited capacity of local suppliers to produce the quantity required according to the standards set by Van Hool. Therefore, the company has chosen a gradual strategy to help develop the local supply chain to meet the standards it requires. The company has several suppliers of inputs into the production purposes. Of these, four are based in North Macedonia one in Serbia and one in Turkey. It is estimated that 10% of the total value of the supplies is bought from local and regional suppliers, mainly in the form of products such as steel, pallets, small boxes, and plastic elements. The strategy for developing the production capacities of the local suppliers consists of support in guiding them through the necessary requirements for the US markets. They support local companies to access loans and finance for their investments in production capacities, helping them to approach local banks by showing the contracts that they have with those local companies and the cash flow they could expect to earn to repay the loans. (Interview, Senior Manager, Van Hool, February 2017).

Local supplier A: Uniplast, Struga

"In 2012 we met with the Van Hool bus producer from Belgium. The negotiation with them was painful. They requested lots of guarantees and imposed lots of penalties in the contracts. If we would accept all what they have requested, then it would be difficult and if not adhering with contract this would have been dangerous. They contacted us even before they started production in North Macedonia. The deal with Van Hool was that we first produced a small quantity for delivery to test in Belgium, and finally at the end of 2012 we got deal (after satisfactory work we did for them as a test) for three types of parts: entering steps for bus, mat guards, save for dust. In 2012 we had 18 employees part time. We kept employees half time because we wanted to keep them although we did not work. Van Hool did not give a request to produce more than those three parts because they were afraid that we could not supply them on time with acceptable quality and quantity they needed. We started to work hard, worked a lot on working conditions. Van Hool understood that we are serious, and we want to grow with them. Now we have 20 parts and 20 more in coming months. Van Hool has supported us a lot. They have production of these parts in Belgium. They were an easy contractor because they knew exactly what they wanted, very specific in their requests, which was not in case of our local customers. Also, they were very open. I have gone in their factory premises in Belgium and made photos and pictures videos which were very useful for myself and my company. Maybe this is seen as a strategic partner. We buy materials from them, and they buy final products from us." (Interview, Senior Manager, Uniplast, Struga, February 2017).

Local supplier B: Aktiva, Stip

Aktiva in Stip was mainly as a result of the process with the Belgian bus company Van Hool, starting from the initial negotiations until the present successful partnership based on loyalty and trust. The cooperation with Van Hool has been a success from the start, followed by the construction of the new plant of Aktiva Automotive for bus chassis welded elements. Aktiva Automotive has also acquired welding certificates compliant with European standards, and it opened a separate welding training centre in 2013 its own needs. The basic elements in establishing a successful cooperation have been consistent production, high quality, timely and stable delivery, competitive prices and loyalty. They have been supported by Van Hool with training material, books and equipment. The interviewee emphasised the important role of the support provided by the team of engineers from Van Hool during the construction of their new plant, which covers 9,000 m². The intensity of this cooperation has led to additional capacity, more jobs, new machines, and even robotic equipment in order to meet the requirements of Van Hool for their factories in Skopje and Belgium. Initially we worked in constructing the building for Van Hool, and then gradually started to work in other areas. First, the company has worked on small projects for Van Hool. This strategy was used to show Van Hool that they could be reliable partners, capable of producing high quality products. It worked for six months to produce chassis welded elements for buses. These six months were used as a test for Van Hool. It produced only 100 elements. The managers visited trade fairs in EU and around the world. The first phase of investment was 20 million Euros specifically designated for Van Hool. As a result, Aktiva has advanced its technology and innovation system and due to that it now works with other companies such as Tuscan Group steel company, winning a contract with the support of Van Hool, showing that the company benefited from being part of a larger network and obtaining contracts with other large companies in the world. Basically, Van Hool has brought this company to a higher technological level. (Interview, Senior Manager, Aktiva, North Maceodnia, February 2017)

6. Conclusions

The CEFTA region has made great progress in expanding regional trade and in attracting FDI to the region attracted by the large market it provides and by low labour costs. However, this success has come at the price of regional divergence of production capacity and export performance. If it is to survive the strains created by such divergences in the benefits of the free trade policies, there is a need to share the gains of progress more widely among all CEFTA partners. This can only be done by ensuring that the new production capacities are embedded in the economies through the redevelopment of regional supply chains that will enable backward spillovers throughout the region. These spillovers will encourage the development of labour force skills, the entry of new SMEs as supplier companies to foreign MNCs in economies such as Albania, Kosovo* and Montenegro, and lead to technology and knowledge transfers throughout the partners' economies.

Due to a lack of capacity among local suppliers, some SEZ-based companies look further afield throughout the Western Balkan region to meet their supply needs. According to one interviewee "we

usually use regional suppliers, because it is quite difficult to find local companies to meet requirements for our company".¹⁹ Companies in SEZs are interested in finding suppliers from Serbia and from Western Balkans region, but many obstacles are preventing the development of these linkages. The small size of local companies and lack of clusters and networking between local and regional companies are among the obstacles for more linkages with foreign companies in SEZs. Research on the development of regional value chains in other regions (e.g., Africa) shows the important role played by several specific factors including transaction costs of cross border trade (Slany, 2017). Reducing such costs is a specific aim of CEFTA, and so should contribute to enabling the development of regional value chains. However, other factors are also important. Chief among these are higher regulatory quality and greater internet penetration. While the latter is improving in the CEFTA partners, the former remains an issue not only for the development of regional value chains but also for economic development more generally. Improved regulatory quality and institutional linkages should be directed to fostering vertical coordination between buyers and sellers. Of particular importance for supplying MNCs, whether based in SEZs or outside such zones, is the length of time taken to trade across borders. Data from the World Bank Doing Business reports show considerable variation among the CEFTA partners with especially long times recorded for Albania, Kosovo* and Montenegro (see Sanfey and Mijatović, 2019). These are the countries which have benefited least from the growth of manufacturing exports linked to the increased presence of MNCs, and so this could be an important policy area for future attention. Sectors such as ICT and software developers, textile, and automotive industry can be potential candidates for regional cooperation.

Government intervention can play an important role in stimulating positive backward linkages between foreign-owned MNCs and domestic components supply firms (Balasubramanyam et al., 1996; UNCTAD, 2001). Local suppliers (SMEs) need support in upgrading their skills, quality, standards and technology. Cooperation (networking) between them also needs to be supported, as well as their cooperation with schools. Although state aid is available to local SMEs (e.g., the RAS programmes in Serbia), more demand could be built. Linkages with IT companies could provide services to SEZ companies, offering IT solutions for their operations, 3D printing, product design solutions, etc. IT services outsourcing is a growing sector in the WB6, but linkages with SEZ based companies are not established.

FDI attraction strategies also need to move to the next phase – to support linkages with domestic SMEs on a regional basis, including SMEs from the IT sector. North Macedonia is already preparing to take this next step. In its Economic Reform Programme 2019-2021 (MoF, 2019) it has prepared measures and planned funds to encourage FDI companies to develop backward linkages with local enterprises. This policy needs to be scaled up to a regional level in order to take advantage of the benefits of backward linkages from foreign MNCs that have been established in the manufacturing sectors of some of the CEFTA countries.

¹⁹ Interview Managing Director, Delphi company, North Macedonia, February 2017

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