STABILITY PACT

SOUTH EAST EUROPE COMPACT FOR REFORM, INVESTMENT, INTEGRITY AND GROWTH

TAX POLICY ASSESSMENT AND DESIGN IN SUPPORT OF DIRECT INVESTMENT

A Study of Countries in South East Europe

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PART III.

LESSONS AND STRATEGIES

This Part consists of 2 chapters. Chapter 15 compares the FDI performance of SEE countries and other neighbouring transition economies competing for investment capital. This assessment is made alongside a comparison of tax policy approaches to attract capital, with a focus on corporate tax systems and incentives used. In addition to the SEE countries reviewed in Part II, in this part we introduce, for comparative purposes, the following other European transition economies – Poland, Hungary, the Czech Republic, the Slovak Republic, Estonia, Latvia, Lithuania, Belarus, Slovenia and Ukraine.

Chapter 16 summarises the main findings and observations drawn from the project, and draws some conclusions relevant to tax policy design and administration. The last section outlines policy options for SEE country officials to consider in determining how best to design a tax system supportive of direct investment.

Chapter 15.

COMPARISON OF TAX POLICIES AND FDI PERFORMANCE

This chapter reviews the experience of SEE countries in attracting FDI, as well as the FDI performance of other transition economies in Central and Eastern Europe competing for mobile investment capital. Alongside this review, we consider the tax policies and incentives employed, with a focus on basic corporate income tax rates and tax incentive features generally thought most relevant to FDI.

A. FDI Performance

1. SEE *Countries*

FDI flows to the SEE countries over the past decade have been relatively modest.[1] Total FDI inflows in the eight Stability Pact countries identified in table 15-1. below over the years 1993–2001 was just over $22 billion. By way of comparison, Poland and the Czech Republic each attracted more FDI over the same period.

Table 15-1. **FDI in the SEE countries, 1993-2001 ($ million)**

	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total 1993-2001	Average: 1999-2001
Albania	68	53	70	90	48	45	41	143	200	758	128
Bosnia	na	na	na	na	1	100	90	150	130	471	123
Bulgaria	40	105	90	109	505	537	819	1002	689	3896	837
Croatia	120	117	121	516	551	1014	1637	1126	1502	6704	1422
Macedonia	na	19	9	11	16	118	32	176	442	823	217
Moldova	14	28	67	24	79	76	40	143	149	620	111
Romania	94	341	419	263	1215	2031	1041	1040	1137	7581	1073
Yugoslavia	96	63	45	0	740	113	112	25	165	1359	101

Source: IMF and National Banks

As might be expected, there has been a fairly steady growth in FDI in SEE countries during the period of transition, although the FDI growth that occurred during 1996-1998 was not maintained in the following two years (perhaps, in large part, as a result of the war in FR Yugoslavia and turmoil in other countries of the region). Romania, by far the largest country in the region, has attracted in aggregate the greatest amount of FDI, followed closely by Croatia.

To the extent that FDI is largely market-oriented in the countries of Central and Eastern Europe, one might expect that those countries that offer larger markets (in terms of GDP and population), and more affluent consumers (as measured by GDP per capita), would not only attract more FDI in total, but also more FDI on a per capita basis – other factors being equal. That proposition seems to be partly borne out by the performance of Bulgaria and Croatia (table 15-2.). Croatia, with a GDP roughly 50% greater than that of Bulgaria, but with not much more than half the population – implying a GDP per capita roughly three times as large – attracted almost twice as much FDI as Bulgaria over 1999-2001, yielding a far greater

amount of FDI per capita. However, Romania, the largest country in the region measured by both GDP and population, attracted much less investment per capita than the smallest country, FYR Macedonia. Yugoslavia, the third largest country as measured by GDP (second largest by population) received the smallest amount of FDI per capita. Clearly, other factors were not equal, and those other factors had a greater influence on FDI performance than market size.

Table 15-2. **GDP and FDI per capita in SEE countries ($ million)**

	Population (million), 2001	GDP per capita, 2001	Total FDI (1993-2001)	Average FDI (1999-2001)	FDI per capita (1999-2001)
Albania	3.4	1210	758	128	38
Bosnia	4.1	1163	471	123	30
Bulgaria	8.1	1570	3896	837	103
Croatia	4.4	4505	6704	1422	323
Macedonia	2.0	1723	823	217	108
Moldova	4.3	344	620	111	26
Romania	22.4	1773	7581	1073	48
Yugoslavia	10.6	1027	1359	101	9

Source: World Bank, IMF 2002, own calculations.

Of the various factors that might be expected to impact on FDI behaviour, captured in table 15-3., there does seem to be some correlation between FDI performance and the perception of risk, which confirms the survey findings and analysis elaborated in Part I. Two of the top countries in terms of per capita FDI and the WIR Index, Croatia and Bulgaria, are also the two with the lowest perceived levels of risk. They also score the highest in terms of (absence of) corruption. At the other end of the spectrum, FR Yugoslavia and Moldova received the lowest amounts of FDI per capita and also had the poorest risk ratings.

Table 15-3. **Factors influencing FDI flows to SEE countries**

	FDI per capita	WIR FDI index	Risk	Freedom	Corruption	Reform	Privatisation
Albania	38	na	62	2.7	Na	2.1	2.5
Bosnia	30	na	na	2.1	Na	1.9	2.5
Bulgaria	103	1.2	67	2.6	3.9	2.8	3.8
Croatia	323	1.4	70	2.6	3.9	2.8	3
Macedonia	108	0.7	na	2.7	Na	2.3	3
Moldova	26	0.9	49	2.6	3.1	2.3	3
Romania	48	0.8	58	2.3	2.8	2.8	3.5
Yugoslavia	9	na	45	1.8	Na	1.5	1

Source: see notes below on measures used in table 15-3.

Summary of measures used in Table 15-3.

(1) WIR FDI index – inward FDI index, published in the World Investment Report 2001. The Index measures total FDI inflow against three factors (GDP, employment and exports) as an indication of FDI performance. A score of 1.0 indicates that a country's performance matches its economic position in terms of the three indicators. A higher score indicates a better-than-average performance in attracting FDI.

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Summary of measures used in Table 15-3. (cont.)

(2) Risk – based on the Composite ICRG risk rating, December 2000 (source: World Bank). Higher scores correspond to lower levels of perceived risk. Of 158 countries listed, Norway and Singapore rated the lowest risk, with scores of 91. Only 10 countries scored lower than 50.

(3) Freedom – based on the Index of Economic Freedom 2002 (Source: The Heritage Foundation). The scores as presented here, ranked 1 to 5, show higher scores for greater levels of freedom.

(4) Corruption – based on the 2001 Corruption Perception Index (Source: Transparency International). Higher scores correspond to lower levels of perceived corruption. Finland recorded the highest (i.e. least corrupt) score, of 9.9 (out of 10). Of 90 countries, 36 scored 5.0 or better.

(5) Reform – based on the Transition Report, 2001 (Source: EBRD). Higher scores represent greater progress in overall institutional reform (the maximum being 4.0).

(6) Privatisation – based on the Transition Report, 2001 (Source: EBRD). This measures progress in large-scale privatisation. A score of 4+ indicates standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.

2. *Other Transition Economies*

In this section, comparisons are made with other transition economies in Central and Eastern Europe, which may be viewed as competing with the SEE countries to attract investment.[2]

Table 15-4. **FDI in Transition Countries of Central and Eastern Europe, 1993-2001 ($ million)**

	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total 1993-2001	Average: 1999-2001
Poland	1715	1875	3659	4498	4908	6365	7270	9342	8000	47632	8204
Hungary	2339	1147	4453	2275	2173	2036	1970	1649	2443	20485	2021
Czech Rep.	654	869	2562	1428	1300	3718	6324	4986	4916	26757	5409
Slovak Rep.	179	273	258	358	220	684	390	2075	1475	5913	1314
Estonia	162	215	202	150	267	581	305	387	538	2807	410
Latvia	44	213	178	382	521	357	348	408	202	2653	319
Lithuania	30	31	73	152	355	926	486	379	446	2878	437
Belarus	18	11	15	105	352	203	444	90	169	1407	234
Ukraine	200	159	267	521	624	743	496	595	772	4437	621
Slovenia	113	128	177	194	375	248	181	176	442	2033	266

Source: UNCTAD 2002, IMF 2002.

As noted above, Poland and the Czech Republic have each received more FDI over the period 1993-2001 than the total for all eight SEE countries ($22 billion), with Hungary close to the mark but with FDI flows continuing to drop off in 2000. Indeed, the steady fall in FDI to Hungary since the peak of 1996 is one of the most striking features of the comparisons, although 2001 saw a sharp reversal of this trend.

As Tables 15-2. and 15-5. reveal, the central European states (Hungary, Poland, the Czech Republic, and the Slovak Republic) have been much more successful in attracting FDI on a per capita basis than have any of the SEE countries, apart from Croatia. To a lesser extent, the same can be said of the three Baltic states. By contrast, Belarus and Ukraine have lagged behind most of the SEE countries.

Table 15-5. **GDP and FDI per capita in Other Transition Countries ($ million)**

	Population (million), 2001	GDP per capita, 2001	Total FDI (1993-2001)	Average FDI (1999-2001)	FDI per capita (1999-2001)
Poland	38.7	4512	47632	8204	212
Hungary	10.2	5133	20485	2021	198
Czech Rep.	10.3	5478	26757	5409	525
Slovak Rep.	5.4	3800	5913	1314	243
Estonia	1.4	3772	2807	410	293
Latvia	2.3	3282	2653	319	139
Lithuania	3.5	3381	2878	437	125
Belarus	10	1207	1407	234	23
Ukraine	49.1	766	4437	621	13
Slovenia	2	9405	2033	266	133

Source: World Bank 2002, IMF 2002, UNCTAD 2002, own calculations.

When other factors are examined that may have influenced FDI flows to the region, it is again evident that risk constitutes an important factor. The two countries rated in Table 15-6. as relatively high-risk, Belarus and Ukraine, also attract by far the smallest amount of investment on a per capita basis. The relationship between corruption and FDI flows is less clear, as the Slovak Republic (and to a lesser extent the Czech Republic) score relatively poorly yet have been quite successful in attracting investment.

At the other end, Ukraine scores very poorly in terms of corruption (no score is available for Belarus). Progress in privatisation also seems to be a significant factor. Slovenia appears to be a rather special case, where despite favourable ratings in relation to risk, corruption, reform and privatisation, FDI has been disappointingly low.

Another factor that seems to be significant to FDI growth potential is proximity to the European Union, not only geographical but also temporal (in terms of potential accession to full membership). All of the transition countries selected for comparison, with the exception of Belarus and Ukraine, have been accepted for admission to the EU in the next round of enlargement in 2004. By contrast, of the SEE countries, only Bulgaria and Romania are currently engaged in accession negotiations, and neither country is included in the group of 10 for the next round. A target date of 2007 has been suggested. Membership of the EU remains a goal of the other SEE countries, but accession to full membership seems unlikely before the year 2010.

Table 15-6. **Factors Influencing FDI Flows to Other Transition Economies**

	FDI per capita	WIR FDI index	Risk	Freedom	Corruption	Reform	Privatisation
Poland	212	1.3	74	3.3	4.1	3.5	3.5
Hungary	198	1.0	72	3.6	5.3	3.6	4
Czech Rep.	525	2	73	3.6	3.9	3.3	4
Slovak Rep.	243	1	71	3.1	3.7	2.8	4
Estonia	293	1.6	74	4.2	5.6	3.5	4
Latvia	139	1.1	71	3.5	3.4	2.9	3
Lithuania	125	1.1	72	3.7	4.8	2.9	3.5
Belarus	23	0.2	60	1.6	na	1.4	1
Ukraine	13	0.3	62	2.1	2.1	2.3	3
Slovenia	133	0.3	76	2.9	5.2	3.1	3

Source: see notes on measures used in table 15.3.

Table 15-7. provides an indication of the progress made by candidate countries in aligning their economies and legislation with EU rules and practices.

Table 15-7. **Negotiations for Accession to the EU**

	Bulgaria	Czech Rep.	Estonia	Hungary	Latvia
Poland	38.7	4512	47632	8204	212
Number of chapters opened	30	29	29	29	29
Number of chapters closed	21	22	20	23	21
	Bulgaria	Czech Rep.	Estonia	Hungary	Latvia
Number of chapters opened	29	29	17	29	29
Number of chapters closed	21	19	9	20	22

Note: As of June 2002. Negotiations are centred on 29 "chapters", each representing a particular aspect of Community law and policy (a 30th chapter, on institutional structure, has yet to be opened). A chapter is provisionally closed when a candidate state demonstrates that its laws and practices are substantially consistent with the acquis communautaire.

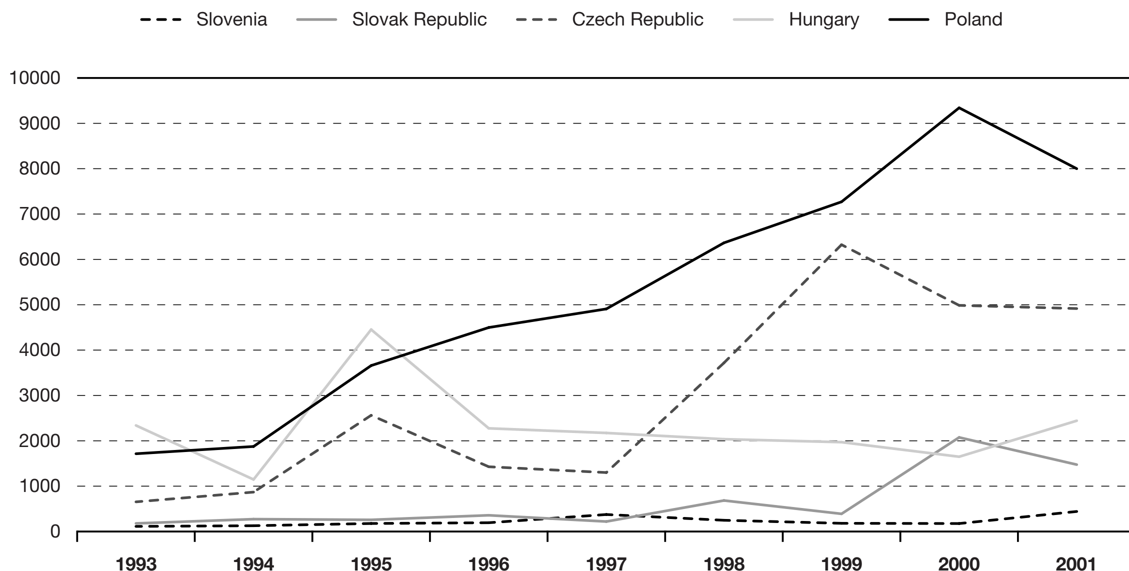
Since there is substantial variation among the countries selected for the purposes of this comparison, it may be more instructive to consider them in a number of groups.

a) The Central European States

The "Visegrad four" – Poland, Hungary, the Czech Republic and the Slovak Republic – were the original members of the Central European Free Trade Area (CEFTA), and were the first of the transition countries to embark upon a programme of economic reform. (Hungary and Poland had, in a limited way, introduced some market reforms and had opened their doors to foreign investment as early as the 1970s.) Consequently, it is not surprising that they were the first among those countries to attract significant amounts of FDI.

As chart 15-1. and table 15-4. demonstrate, Hungary was off to an early start in terms of the competition to attract FDI. In terms of annual flows, Hungary was not overtaken by Poland until 1996, by the Czech Republic until 1998, and by the Slovak Republic until 2000 (with a reversal observed in 2001). In terms of total amount invested, it led the field until 1998.

Chart 15-1. **FDI Flows to the "Visegrad Four", 1991-2000 ($ millions)**



What is striking about the Hungarian performance is the sharp decline in FDI, since the peak in 1995, up until 2000. In terms of risk, corruption, progress in reform and in privatisation, Hungary scores as well as, or better than, its competitors within the region. Nor do there seem to have been any major shifts in policy, or other causes of instability. One possible explanation for the relative decline is that labour costs have risen more steeply in Hungary than in its neighbours.

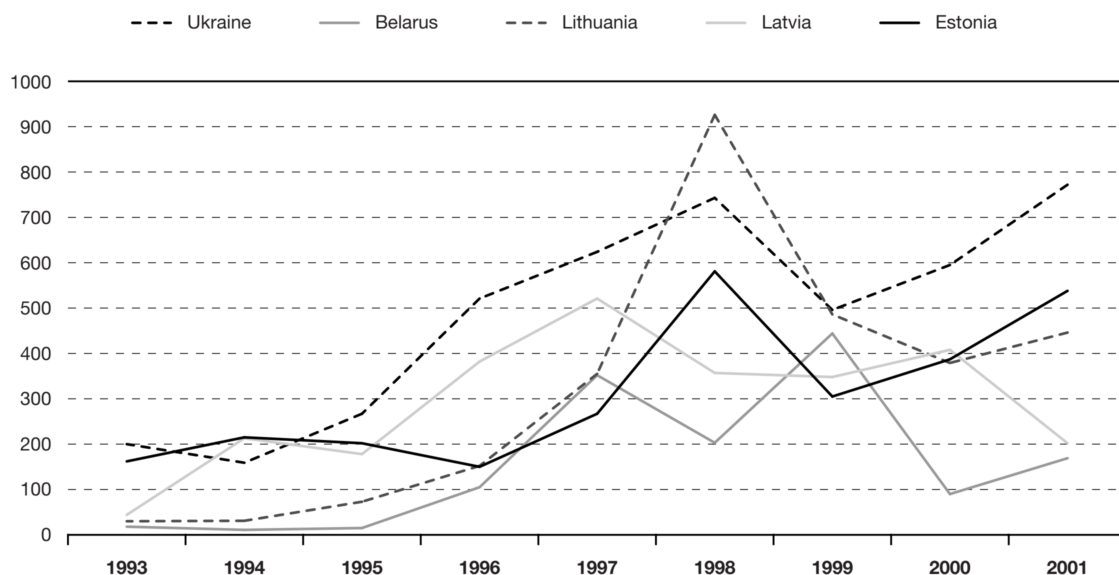
Another consideration is that its neighbouring countries have become more open to FDI, as evidenced by their increasing use of tax incentives in recent years, reviewed later in this chapter. However, the most likely explanation lies in the fact that the privatisation process in Hungary reached its peak in 1995, with over $3 billion of state-owned assets privatised, and was virtually complete by 1999.[3] Other countries of the region were later in commencing their privatisation programmes, with some still receiving substantial amounts of FDI that are privatisation-related. The explanation draws further support from the fact that privatisation has progressed further in the Czech Republic, where it is now almost complete, compared with Poland:[4] FDI into the Czech Republic peaked in 1999 and declined in 2000, whereas it has continued to rise in Poland.

The Slovak Republic differs in some respects from the other countries in this group. It is substantially smaller, thus offering a smaller domestic market, at least for certain products. It is also more remote and does not border any EU member country. Furthermore, unlike the Czech Republic, Hungary and Poland, it was not, until quite recently, considered likely to be among the first wave of new members to accede to the EU. Additionally, the Meciar government, which led the Slovak Republic following independence in 1993, was widely seen as less than enthusiastic about the need to introduce market reforms. The election in 1998 of a more reform-minded government open to policies to attract FDI, the general acceptance of the country into the international community,[5] and the increased possibility that the Slovak Republic might after all be included in the first wave of new EU members, have all contributed to a rise in FDI inflows since 1997.

b) The Baltic States

The three Baltic states – Estonia, Latvia and Lithuania – regained their independence in 1990-91. Although the three countries are very different in many respects, they do have a number of common characteristics, apart from their geographical location and the fact that they formerly constituted part of the

Chart 15-2. **FDI flows to the Baltic Countries, 1991-2000 ($ million)**



Soviet Union. In particular, they are all relatively small countries, with a roughly similar GDP, and they have received similar amounts of FDI since 1991.

As chart 15.2 illustrates, Estonia, the smallest of the Baltic states in terms of population, commenced its economic reforms and privatisation programme rather earlier than its neighbours, and largely as a result had received more FDI prior to 1994 (overtaken by Latvia in 1994). While it has been overtaken subsequently by both Latvia and Lithuania in terms of aggregate annual FDI inflows, it continues to generate the highest GDP per capita of the Baltic states, and has the highest level of FDI per capita. The fluctuations in annual FDI inflows reflect, to some extent, the larger privatisations: for example, the telecom privatisation comprised more than half of the total investment in Lithuania in 1998 (the record year).

None of the Baltic countries shares a border with a EU member, although Estonia is separated from Finland by only a few kilometres of sea. All three countries entered into negotiations to accede to the EU and have been accepted for the next round of enlargement.

c) Belarus and Ukraine

From the point of view of potential investors, Belarus and Ukraine share a number of characteristics that distinguish them from either of the groups considered above. Their history, as part of the Soviet Union for some 70 years, and their geographic location distanced from the EU, are significant factors. So too is the fact that neither country is considered as a potential member of the EU, at least in the foreseeable future.

Perhaps of more immediate relevance is the fact that both countries are perceived as relatively high-risk locations for investment, with a high level of corruption,[6] and also with significant government intervention in the economy. Market reforms have been very slow in coming, and privatisation has barely begun in Belarus. Consequently, per capita FDI flows have been significantly lower than in most of the SEE countries.

d) Slovenia

Based on earlier analysis finding a fairly strong link between FDI flows and per capita GDP, Slovenia remains something of a mystery. Although it has a small population (although larger than Estonia), it would seem to hold many attractions to foreign investors. Its per capita GDP is at least twice that of any of the other transition countries considered in this part; it borders on two EU member countries; it is among the first wave of new EU members; it has the lowest (i.e. best) risk rating of any of the transition economies; and it rates well on the corruption index. Yet it has received comparatively little FDI, both in total and on a per capita basis.[7]

One explanation is that Slovenia has attached rather less importance to attracting FDI than have the other countries in central and South-East Europe. Until 1999, there were a number of restrictions on foreign investment: for example, the managing director of any company had to be a Slovenian national and foreigners were not permitted to own land. Furthermore, privatisation of state-owned sectors has been slow. According to the EBRD *Transition Report* 2001, Slovenia's cumulative privatisation receipts between 1989 and 2000 amounted to just 2.5% of GDP in the 24 countries of Central and Eastern Europe this put Slovenia in 21st place, well behind other EU accession candidates, which average around 10% of GDP. This is attributed by some to a concern, on the part of the Slovene public, that the sale of strategic assets to foreigners will result in a loss of sovereignty.[8]

B. Tax Systems, Rates and Incentives

This section reviews host country tax systems, tax rates and incentives in SEE countries and other transition economies, with a focus on direct taxation and corporate income tax in particular. Customs policies are discussed, but principally within the context of incentive measures.

The special focus on corporate tax policy is taken for a number of reasons. While customs policies and administration issues are important, a detailed account and comparison of customs regimes for the 19 countries reviewed is beyond the scope of this study. Comparing the impact of customs duties is complicated by the fact that applicable provisions relevant, for example, to imports of machinery and materials from affiliates, may vary according to the nationality of the investor. Indeed, the majority of countries considered here have concluded free trade agreements in one form or another with the EU. Thus, investors from EU countries gain an advantage over those from non-member countries (e.g. Japan, the United States), making comparisons difficult.

Second, customs regimes, along with VAT, have been the subject of much discussion and reform in recent years in SEE countries, largely within the context of aligning basic principles and approaches to the EU framework. Thus providing a perspective on corporate income tax, and related incentives and provisions seems most warranted.

Third, corporate tax rules impact directly on multinational corporations, and much pressure has been brought to bear on SEE countries to lower their corporate tax burden to secure FDI. Indeed, the range and generosity of corporate tax incentives introduced, and the low percentage contribution of corporate tax to total revenues in most SEE countries, suggest that multinationals have been quite successful in arguing that effective host country tax rates on profits must be kept to a minimum.

However, where multinationals locate in SEE countries typically on the basis of business as opposed to tax considerations, and are able to largely avoid additional tax on repatriated profits, it is prudent to consider whether countries could do better by raising their effective corporate tax rate above a low or nominal rate. The results could be positive to FDI, particularly where higher host country tax revenues are used to finance programs central to the development of an enabling environment. (e.g., infrastructure renewal and expansion, strengthening of legal systems).

The closing summary section of this chapter examines the evidence with an eye towards viewing realistically the ability of special tax incentives to attract and retain real investment in SEE countries. Where special tax incentives are not found to encourage FDI, it is useful to examine what tax measures can be streamlined, reformulated, and made more transparent, along with reforms to address other features of the tax system that may be impeding investment flows.

1. SEE C*ountries*

The tax systems of the eight SEE countries were examined in some detail in Part II of this report. Some general observations may be drawn here.

The corporate income tax systems in all of the countries are fairly conventional, adopting essentially the "classical" model, and in most cases applying final withholding tax on dividends paid to domestic individuals.[9] Exceptions apply in FYR Macedonia and Serbia, which impose tax at the personal shareholder level. Under Macedonia's system, personal tax is levied on dividends received, with a personal tax credit for tax withheld at source. Serbia's partial inclusion approach is somewhat unique. Tax is first withheld at source on 50 per cent of distributed profit (giving an effective withholding tax rate of ten per cent), and rather than providing a credit for this tax, shareholders are taxed on half of dividends received. This results in a slightly higher effective personal tax rate than if dividends received were taxed in full, with credit for withholding tax.

All of the SEE countries adopt a broadly similar approach to the computation of taxable income, although the rules on deductible expenditures may be seen as somewhat restrictive in Albania, FYR Macedonia and Serbia and Montenegro.

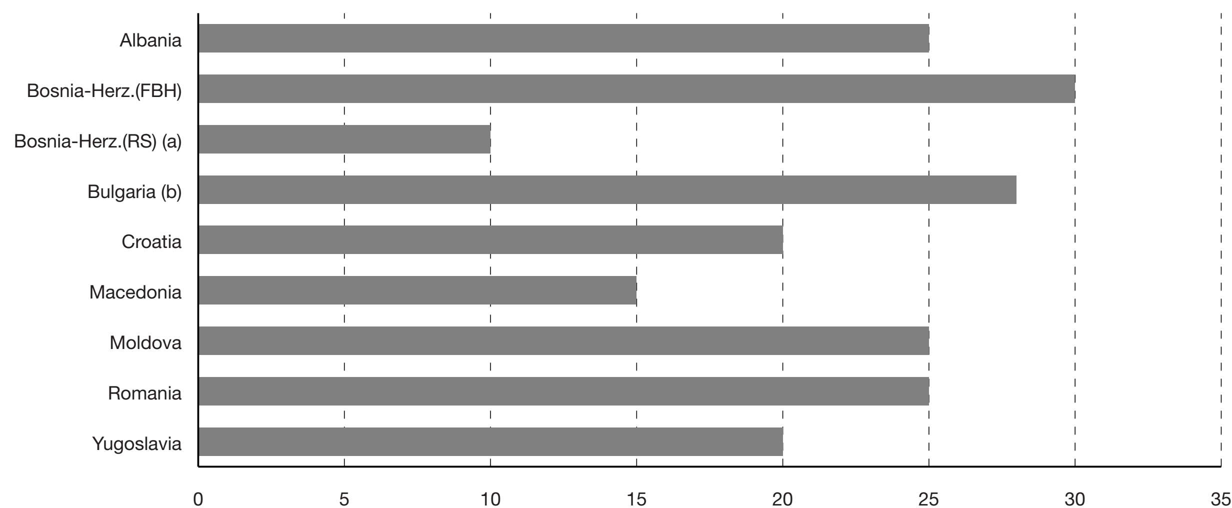
Over the past decade there has been a fairly steady reduction in CIT rates throughout the SEE region, mirroring worldwide trends, and perhaps evidencing an element of tax competition. Chart 15-3. shows where

basic corporate income tax rates stood on 2001. None of the countries have what would be considered high statutory corporate tax rates. Of course, the statutory rates, while relevant to tax-planning incentives, do not tell the full story in determining effective tax rates: the determinants of the tax base, and special tax incentives must also be factored in.

The depreciation systems appear to differ considerably across SEE countries in terms of their level of complexity (although it is unclear from certain questionnaire responses whether full detail was provided). In certain cases, most notably perhaps in the case of Serbia and Montenegro, scope would appear to exist for simplification of depreciation frameworks, perhaps in combination with more generous depreciation provisions.

Most of the countries permit losses to be carried forward for five years. However, Albania and FYR Macedonia permit only a three-year loss carry-forward, and Moldova appears to provide no loss relief at all. Provisions denying loss carry-forwards beyond three years may be seen as impeding investment, particularly when judged against international norms. The rules are particularly onerous where depreciation claims are mandatory, as they are in most SEE and other transition economies. There are also important considerations as regards the interaction of loss provisions and investment incentives, particularly investment allowances (addressed below).

Chart 15-3. **Statutory CIT Rates in the SEE Countries, 2001**



Notes: The CIT rates shown are those applicable to retained earnings (as opposed to distributions).
FBH denotes Federation of Bosnia Herzegovina; RS denotes Republic of Srpska
(a) The rate shown is the top CIT rate (under a regressive schedule)
(b) The rate shown is the top CIT rate (under a progressive schedule)

Certain differences are found in the treatment of intercorporate dividends. Bulgaria and Macedonia (FYR) waive such dividends from withholding tax at source, imposing withholding tax only when profits are ultimately distributed to individual shareholders. Albania limits the exemption to distributions to related companies as a means of eliminating multiple-taxation of profits distributed along a (related) corporate chain. Distributions to unrelated companies are subject to withholding tax (at 15 per cent, versus ten per cent on distributions to resident individuals), which is creditable at the intermediary level. Romania levies withholding tax on intercorporate dividends without relieving measures, tending to discourage vertical corporate structures. Serbia also levies withholding tax on intercorporate dividends, but relies on a gross-up and credit system at the corporate level to relieve withholding and (notional) corporate tax paid at source.

Personal income taxes are generally fairly low the top rate varies from a low of 18% (FYR Macedonia) to a high of 40% (Romania), although the thresholds for the highest rate, being related to local income levels, are relatively low. By contrast, payroll taxes and social security contributions are significant, and vary from 32% to about 53% of wages. In most of the countries the largest portion is paid by the employer.

a) Investment Incentives

The investment incentives granted by the SEE countries have been described in Part II, and so a detailed recount is not necessary here. However, a review of those sections reveals a number of important observations.

In examining the current state of play in the SEE countries in the tax incentive area, one observes that most countries have moved towards adherence to national treatment, and in some cases full adherence. While in the past incentives were overtly targeted at foreign investors, today, this is not the case, although instances of such targeting can still be found. Whether the adjustments toward national treatment were motivated by international obligations, or out of concerns over negative consequences of denying incentive relief to domestics (reviewed in Chapter 4), or out of a recognition that in practice foreign investors are the main beneficiaries of direct tax incentives, this reorientation is an encouraging development.

The review of current and past incentive use in recent years is also illuminating. All SEE countries have tested a variety of tax incentives in the past, often with seriously disappointing results, and have moved to eliminate or replace them. A number of countries have changed their tax incentive provisions significantly over recent years: Bulgaria and Romania, in particular, have followed rather erratic courses, removing incentives and replacing them with others at regular intervals. At the same time, SEE officials have recognised the importance of establishing credibility in the tax policy area to investors, and the corresponding need to provide "grandfathering" provisions, despite the ensuing revenue losses.

Currently, one observes widespread reliance on VAT and customs duty exemptions and zone incentives. Outside its zone legislation, Albania limits its VAT and customs duty relief to a three-year deferral for purchases, or in-kind share contributions, of machinery and equipment. Raw materials are exempt for customs duty, but only for inward processing for ultimate export.

All SEE countries currently have zone legislation, with varying degrees of incentive relief and take-up activity. In Albania, while zone legislation has been drafted, no such zones have been established. This may be at least in part explained by the fact that corporate tax relief (e.g. tax holidays, profit exemptions) are not on offer, whereas they are in zones in other SEE countries.

Investment expenditure-based incentives are currently used in all SEE countries, in some countries more faithfully than others. While examples of an investment tax credit and investment allowances can be found, one observes a preference for the investment allowance variety. This is clearly the case in FYR Macedonia, which currently employs no fewer than three variants – one targeted at environmental protection, another targeted at regional activities, and a third that is more general in application. In each case, the full amount (100%) of expenditure on qualifying assets may be set off against taxable income. This is also the case for investment allowances provided in Bosnia and Herzegovina.

However certain overall limits may apply. FYR Macedonia caps its regional allowance at 50% of taxable profit, for example, whereas its general allowance is subject to a 25% cap. Similarly, the Republic of Srpska caps its allowance at 15%. On the other hand, the environmental allowance in Macedonia is not subject to a cap, nor is the investment allowance in the Federation of Bosnia and Herzegovina.[10] Unrestricted investment allowances may be problematic to the extent that they enable the conversion of unutilised tax allowances into tax losses, which can then be carried forward subject to loss carry-forward restrictions. Even where the allowances are capped, their interaction with other provisions (e.g. accelerated depreciation) may have a similar effect.

Another interesting variant is the approach taken by Romania, where the allowance appears to be strictly targeted at investment financed by retentions, rather than debt-financed investment or investment financed by new share issue. The general reinvestment allowance also differs from those noted above in that half rather than the full amount of expenditures on qualifying assets may be deducted from taxable profit, while the SME reinvestment allowance permits the full amount to be deducted. The reinvestment allowance for large investment projects is earned at a 20% rate, which is supplemented with accelerated depreciation provisions which boost the first year deduction to 70% of qualifying investment expenditures.

Reliance on a reinvestment allowance may be motivated by an effort to encourage foreign direct investors to reinvest profits in Romania, rather than distribute those earnings to parent or holding companies abroad. But given the aim of encouraging domestic investment, it is not clear why investment financed by new share issue would be denied relief. If a concern exists over highly-leveraged firms, given the base-eroding effects of interest deductions, attention to other policy areas might be preferable to a source of funds restriction. Such areas could include introducing thin-capitalisation rules (currently Romania does not have such rules), and revisiting policies towards the setting of non-resident withholding tax rates on interest paid to treaty partners that do not tax interest income.

The only SEE country relying on the investment tax credit variant was Serbia. The credit follows very closely international norms in the use of this measure, with credits earned on qualifying capital at a 10% rate, and with total claimed credits capped to not exceed 50% of tax otherwise payable. A richer variant is targeted at SMEs, with the credit rate increased to 30% and the cap lifted to 70%.

Croatia, FYR Macedonia, Romania and Serbia all promote their corporate systems as offering accelerated depreciation. However, while the relevant provisions for Croatia and Macedonia do provide for depreciation of qualifying assets at a faster rate (25% higher) than would otherwise apply, it is unclear whether these higher rates are actually higher relative to true economic depreciation. Accelerated depreciation appears more likely in Croatia, which doubles its depreciation rates for targeted capital, and Romania which, as noted above, provides a first-year deduction of 50% of qualifying depreciable capital costs as part of its “large project” incentive programme.

Despite the disappointing results associated with profit-based incentives – those offering tax relief as a percentage of profits of qualifying firms – it is unfortunate that a number of SEE countries continue to use them. In some cases, tax holiday and partial profit exemption incentives are available without regional restriction. In others, their application is targeted at profits derived from zone activities. Wherever used, however, it is highly unlikely that such incentives would be found to be efficient given the tax-minimisation opportunities created, unless qualifying firms are audited on a regular and professional (arm’s length) basis.

Targeting such relief to zones may help limit incentive abuse – in particular, related-party transactions and financial structures aimed at artificially characterising non-targeted profits as profits from zone activities. The use of zones would tend to limit the number of firms eligible for profit exemptions, and increase prospects for auditing of tax accounts to establish if profits are in determined on an arm’s-length basis. However, in practice it is unclear whether this potential is realised. Without safeguards ensuring transparent and arm’s length relationships between zone companies and tax officials administering incentives, a zone programme – by bringing together tax officials and select companies to negotiate an agreement on zone activities – may contribute to and institutionalise a setting that is ripe for corruption. In other words, zone programmes providing for profit exemptions may feed rather than lessen scope for abuse and corruption.

As noted, the use of profit-based incentives is widespread in the SEE region. Indeed, all of the countries considered resort to these incentives, with the exception of Albania and Bulgaria. Bosnia and Herzegovina, FYR Macedonia and Moldova all offer tax holidays targeted explicitly at FDI. Firms that are entirely foreign-owned enjoy a five-year tax holiday in Bosnia and Herzegovina, compared with a three-year holiday in Macedonia. Firms satisfying a minimum foreign participation threshold (20%) enjoy a partial profit exemption in both countries, with the exempt proportion in FYR Macedonia tied to the proportion to foreign participation,

and in Bosnia and Herzegovina, set at fixed, descending amounts (100%, 75%, 30%) over a three-year period. Foreign participation of at least 30% (or investment of at least $250,000) triggers a tax holiday of one to six years in Moldova, subject to turnover restrictions. Tax holidays in Croatia at ten years, standing out as the most generous of those examined, may be seen as implicitly targeted at FDI, given the requirement of a minimum of $7 million invested (or alternatively 75 new jobs created).

Regionally-targeted tax holidays and other variants are also observed. In the Republic of Srpksa, a three-year tax holiday provided to new firms operating in regions designated as underdeveloped. In Serbia, profits on activities in underdeveloped regions may be fully exempt for two years. Special tax holidays of up to five years are also available in Serbia for profits derived from concession contracts. Other variants also exist, including the 50% profit exemption for listed-companies in FYR Macedonia.

While Albania and Bulgaria stand out from the rest in not providing a "carte blanche" to MNEs in setting their own effective corporate tax rate, it is noteworthy this vision has been learned the hard way. Prior to 1999, Albania gave a 4-year tax holiday to domestic and foreign-owned enterprises engaged in manufacturing activities. Following the holiday, manufacturing firms were provided with a 60% profit exemption. This programme was found to be inefficient, and difficult to administer. Particularly difficult to administer was the requirement that tax be paid *ex post* on profits exempted over the holiday period in the event that firms terminate their activities following the holiday. The Albanian rules contained a provision requiring that the manufacturing activities, qualifying for the holiday, continue for six years (for a total of ten) beyond the holiday period). Such provisions, typical under most tax holiday programmes, are notoriously difficult to enforce. The Albanian tax holiday was also found to be open to corruption, given discretion over the selection of qualifying firms, and the overall prevalence of non-arm's length relationships between officials and those firms.

Similarly, Bulgaria provided a three-year tax holiday to foreign-controlled firms (satisfying a 50% foreign ownership requirement), followed up with a 50% profit exemption for two years. For priority investment projects (in excess of $5 million), the 50% profit exemption was available for ten years. Again, the programme was found to be inefficient, open to taxpayer manipulation, and prone to rent-seeking behaviour on the part of tax officials.

Table 15-8. **Investment Tax Incentives in SEE Countries (2001)**

	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	Macedonia	Moldova	Romania	Yugoslavia (FR)
Tax holidays		X		X	X	X		X
Partial profit exemption		X			X			
Preferential CIT rate				X			X	
Accelerated depreciation			X	X	X		X	X
Investment allowance		X			X			
Reinvestment allowance							X	
Investment tax credit			X					X
Customs duty exemption		X		X	X	X	X	X
Customs duty deferral	X							
VAT exemption							X	
VAT deferral	X							
Special zones offering:								
>Customs duty exemption	X	X	X	X	X	X	X	X
>VAT exemption			X		X	X	X	
>Tax holiday (CIT exemption)		X		X	X	X	X	
>Other tax exemptions		X			X		X	

Note: These provisions apply as of 2001. See Part II "post-scripts" to country chapters (and footnotes) for partial coverage of policy changes introduced in 2002.
Table reports incentives available for new investment (ignores "grandfathering" provisions)

A particularly striking and important finding is that one currently observes a perplexing combination of generous tax incentives in a number of SEE countries, alongside restrictive rules governing basic tax treatment (e.g. treatment of losses). Other tax impediments to investment are also observed, including complex and cumbersome depreciation rules. These provisions, set out in Part II, are revised in Chapter 16.

2. *Other Transition Economies*

a) Tax Systems

Although a majority of the Central and Eastern European countries have quite conventional corporate income tax systems, adopting the classical approach (or, in the case of the Czech Republic, a partial integration system), several of the countries studied have quite unusual and interesting systems. The Latvian system is somewhat rare, in that it offers relief from double taxation by means of the "dividend exclusion" method: that is, profits are subject to corporate tax alone, with no withholding tax or any further tax imposed on resident recipients of dividends. (A withholding tax is imposed at, 10%, on dividends paid to non-resident companies and individuals, although that rate may be reduced by treaty.) Three of the systems – those of Estonia, Hungary and Lithuania – provide a substantial preference for retained, as opposed to distributed profits.

The present Hungarian tax system has evolved in stages.[11] Prior to 1995, the Hungarian corporate income tax was of the classical type, with a rate of 36%. As from 1 January 1995, the basic CIT rate was halved, to 18%, but a "supplementary tax", levied at 23%, was imposed on distributed profits. That system was modified in 1997, and the supplementary tax was replaced by a withholding tax on distributions, levied at 20%. For domestic investors, the change was not especially significant, apart from a small, three percentage-point reduction in the tax on distributions. For most foreign investors, however, the change was highly beneficial. While the supplementary tax had been regarded as a tax on corporate income, the new withholding tax was characterised as a withholding tax on dividends, and was reduced under the provisions of Hungary's tax treaties, usually to 10% or 5%. Thus while the supplementary tax had been eligible (in the home country) for an underlying foreign tax credit, this benefit was of little use where further tax on distributed profit could be avoided. In contrast, treaty reductions in the withholding tax rate brought immediate tax relief.[12]

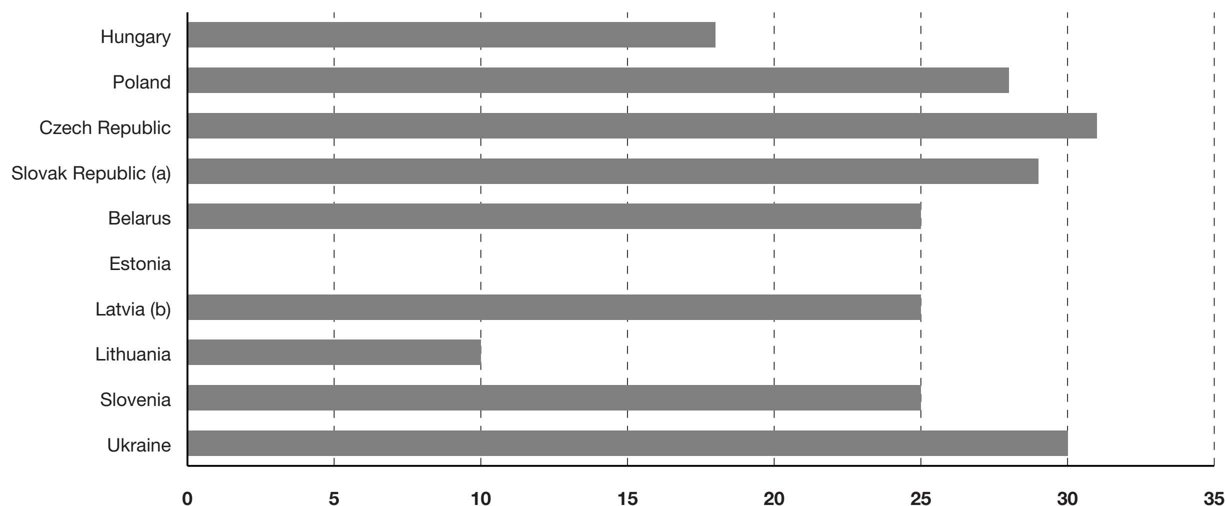
The Lithuanian system also provides a preference for retained profits, applying a reduced CIT rate of 10% in the case of reinvested profits.[13] Distributed profits are taxed at the rate of 24%, reduced from 29% during 2000. The government has announced its intention to reduce the rate to 15% (and to remove the preference for reinvested profits), and there have even been proposals to eliminate the CIT entirely.

The Estonian system is perhaps the most interesting, and has certainly attracted some attention.[14] In December 1999, a law was adopted (effective January 1, 2000) which abolished the corporate income tax. At the same time, a special "distributions tax" was introduced, at the rate of 26%, applicable to dividend payments to both resident and non-resident shareholders.[15] Apart from the complete exemption for retained profits, the Estonian system differs from the Hungarian in that the tax on distributions is not a withholding tax and is consequently not reduced under tax treaties.[16]

The CIT rates in all ten "other transition" countries are relatively low by international standards, although comparable with the rates in the SEE countries. As illustrated in chart 15-4., excluding the special tax systems operating in Hungary and Estonia, the CIT rates range from 24% to 31%. It seems unlikely, in view of this relatively small difference, that the tax burden has had much influence on investment decisions. Indeed, the Czech Republic has the highest tax rate as well as the best WIR Index score, and the major tax reduction in Hungary coincided with the beginning of the decline of FDI into that country.

With the exception of Belarus,[17] all of the countries allow losses to be carried forward for at least five years, although some restrictions apply in Poland and the Slovak Republic. Hungary permits start-up

Chart 15-4. **Statistical CIT Rates in Transition Economies, 2001**



Notes: The CIT rates shown are those applicable to retained earnings (as opposed to distributions).
(a) The CIT rate is reduced to 25% as from 2002.
(b) The CIT rate is reduced to 22% as from 2002.

losses to be carried forward without limit. Payroll taxes and social security contributions range from 33% to 51%, comparable to those of the SEE countries.

b) I*nvestment* I*ncentives*

The investment incentive approach employed by the other European transition countries also varies considerably, both in terms of types of incentives and levels of tax relief offered. The following discussion, and table 15-8., concentrates on incentive regimes in 2001, beginning first with some observations on past incentive use. For convenience, the discussion focuses separately on the central European states, the Baltic States and other selected countries in eastern Europe.

ba) T*he* C*entral* E*uropean* S*tates*

Czechoslovakia (pre-1993), Hungary and Poland were the first of the Central and Eastern European countries to embark on economic reform and to open their doors to foreign investment. In the earliest stages of transition, foreign investors were given special privileges in the form of tax holidays and reduced CIT rates, given that basic CIT rates were unusually high and most domestic firms were state-owned.

Between 1989 and 1992, these preferences to foreign investors were largely phased out. In their place, Hungary and, to a lesser extent, Poland introduced new incentives available to foreign and domestic investors. By contrast, Czechoslovakia and subsequently the Czech Republic, did not take the same approach to attract investment. Following the separation, the Slovak Republic introduced some incentives, although these were on a rather limited scale.[18]

This situation began to change around 1995, with the establishment in Poland of the first of its special economic zones. Two further special zones were established in 1996, and by the end of 1997 there were 19 such zones located throughout the country. Investors in the zones enjoyed substantial tax benefits, principally in the form of a complete tax holiday for ten years,[19] followed by a further period of up to ten years during which CIT was levied at half the normal rate.

The Polish measures were widely regarded as a response to the generous tax holidays that were granted to large investors in Hungary. One effect was to encourage a similar response in the Czech Republic. Following the change of the Czech Government in 1997, more investor-friendly policies were introduced, and generous tax holidays were granted for large investments. The Slovak Republic was the last to enter the competition, introducing new (and more generous) tax holidays in 1998, and further relaxing the qualifying rules for tax incentives in 1999 and in 2001.

There is little doubt that tax competition among the four countries has been a major driver behind these incentive policies. It is interesting that the pattern of FDI flows within the region does appear, at least on the surface, to reflect shifts in tax policy. Hungary, with the most liberal incentive regime, was the early leader in attracting FDI. Poland's rise to first place, in terms of annual FDI flows among the countries of Central and Eastern Europe in 1996 (see table 15-4.), coincided with the introduction of the special economic zone regime in 1995. And the Czech Republic saw a large increase in investment in 1998 after the introduction in 1997 of tax incentives. Similarly, the growth in FDI in the Slovak Republic coincided with the introduction of more generous incentives.

However, these observations ignore the possibility that other factors had an important, and arguably more important influence on FDI flows to the region. As already reviewed, foreign investment in Hungary started to decline in 1996 when the privatisation process was almost completed, while privatisation began later in the other countries (and continues in some cases). Also, especially in the Czech and Slovak Republics, the introduction of tax incentives was but one element of new investor-friendly policies. Tax incentives currently available in the four countries are identified below in table 15-13.

A full description of the changes to the system of tax incentives in the transition economies of Central and Eastern Europe is beyond the scope of this paper. Thus the following descriptions concentrate on main incentives in place in 2001.

i) P*oland*

With the elimination of the investment allowance in 2000, tax incentives are restricted to investments made in designated special economic zones (SEZs). There are presently 17 such zones, two having been discontinued. Each zone was established for a period of 20 years, apart from the two technology zones of Krakow and Mazowiecka, planned to exist for 12 years.

The tax incentives originally granted in the zones were especially generous. A full tax holiday was granted for ten years (six years in the two technology zones), with a 50% profit exemption for the remainder of the investor's existence of the zone. The relief was conditional upon the amount invested and/or number of persons employed.[20] The continued existence of these provisions under the SEZs, however, is incompatible with the EU rules on state aids, and as from the beginning of 2001 the incentives have been revised. In place of tax holidays, investors receive a "tax refund" (in effect an investment tax credit) of up to 50% of the amount invested.[21] The main point of controversy, in Poland's negotiations with the EU, has been over the treatment of existing investors who are currently enjoying tax holidays.

ii) H*ungary*

Over the past 15 years or so, Hungary has provided a variety of tax incentives to attract foreign investors. Most of those incentives were discontinued with the introduction of the two-tier CIT system in 1995. However, a number of incentives remain, for the most part targeted at larger investments. Investments of at least HUF 1 billion (approx. US $4 million) earn a 50% profit exemption (giving a 50% reduction in CIT) for a period of 5 years.[22] In the case of investment made in a designated underdeveloped region, a full profit exemption (tax holiday) may be granted for 5 years. For manufacturing investments exceeding HUF 10 billion, or 3 billion in underdeveloped regions, a tax holiday may be given for a period of up to ten years. The incentives are conditional on the creation of a stipulated number of new jobs. These incentives will expire in 2011.

Investments in qualifying regions may also benefit from investment tax credits and special depreciation regimes. Other incentives include an exemption from dividend withholding tax for funds that are reinvested in Hungary,[23] and the double deduction of social security contributions for firms employing previously unemployed persons.

More than 100 duty-free zones have been established in Hungary, principally for manufacturing firms that export their total production. Almost all of these will disappear when Hungary becomes a member of the EU. Hungary has also enacted a special regime for offshore companies, which was included by the OECD on its list of preferential regimes considered to constitute a potentially harmful tax practice.

iii) Czech Republic

A new Investment Incentive Law took effect in May 2000, replacing earlier legislation, but with "grand-fathering" provisions to ensure that previous incentives continue to apply to previous investors according to the terms and conditions under which they were granted. Under this new law, both tax and certain non-tax incentives may be granted to investments exceeding roughly $10 million.[24] The granting of the incentives is discretionary. However, the general conditions that apply are published, as are details of incentives actually granted. In the period 1998-2001, tax incentives were granted to roughly 100 companies, about 90% of which were foreign-owned.

The principal tax incentive introduced in 2000 takes the form of a tax holiday, for up to 10 years, targeted at newly-established enterprises. Existing enterprises in 2000 were given a tax exemption, for 5 years, on any increased profits compared with average taxes paid over the two prior years. In addition, investment allowances are available, at rates varying between 10-20%, depending on the types of qualifying fixed assets acquired, and an exemption from customs duty applies to qualifying new machinery.

A number of free trade zones have been established for companies that export 100% of their production, although these will have to be modified to meet EU rules. There are also several industrial zones and technology parks: no special tax privileges are granted for investors in the zones, although they are eligible to receive incentives under the general provisions.

iv) Slovak Republic

Under the original (1993) legislation, the principal investment incentive was a tax holiday for one year or two years in certain less developed regions. Preferential (reduced) CIT rates applied to firms engaged in agricultural production and to firms employing a given percentage of disabled workers. Starting in 1998, a number of new incentives have been introduced. Under the current rules, new enterprises engaged in manufacturing or in the provision of qualifying services may qualify for a complete tax holiday (full profit exemption) for a period of 5 years. To access this holiday, the company's paid up capital must exceed EUR 4.5 million (3 million in areas of high unemployment), and foreign investors must own at least 60% of the capital throughout the holiday period. Following the holiday period, foreign investors may be granted a (renewable) 50% profit exemption, for five years, provided that an additional EUR 4.5 million (3 million in areas of high unemployment) is invested.

Additionally, investment (by any enterprise) in R&D activities qualifies for a tax credit earned at the rate of 20% of the amount invested. Qualifying machinery and equipment may be imported free of customs duty if contributed to the foundation capital of the company.

bb) The Baltic States

The three Baltic states have all tended to rely more on low rates of CIT than on special incentives in order to attract investment. Currently, very few incentives are offered.

i) Estonia

With the abolition of the corporate income tax, special reliefs from CIT became irrelevant. Existing companies that were entitled to tax holidays under earlier legislation are subject to the distribution tax in the same way as other companies. Estonia has also abolished all customs duties on imports. It seems that the only companies still enjoying tax concessions are those established before 2000 in one of the three free economic zones.

ii) Latvia

Tax holidays were eliminated in April 1995: existing firms that qualified were entitled to retain their holiday to the end of the prescribed period, but since the holidays were for only 2 years, with a further two years at half rate, these are no longer in force. In place of the tax holidays, an investment tax credit was introduced, equal to 40% of the amount of eligible investments. A tax credit for investment in high-technology products is also available, and investors in designated special regions may claim accelerated depreciation allowances. Relief from customs duty may be given in respect of property forming part of the investor's contribution to the company's capital.

Two special economic zones have been established in Latvia and are planned to continue until 2017. Investors in the zones [25] are entitled to a) an 80% profit exemption, making the effective CIT rate 5%, b) immediate expensing of capital expenditure, and c) reduced withholding tax on dividends, royalties and management and consultants fees paid to non-residents.

iii) Lithuania

Prior to 1996, investors in Lithuania could be granted partial tax holidays from CIT (50% profit exemption) for a period of six years. This concession no longer exists. The only current tax incentives for FDI are the exemption from customs duty for property imported by a foreign investor as a contribution to the authorised capital of the company, and those incentives that apply to the three free economic zones (in particular an 80% profit exemption for a period of five years, with a further five-year 50% exemption).[26]

bc) Other Countries of Eastern Europe

Belarus, Ukraine and Slovenia all provide tax incentives for foreign investors. A summary of main incentive use follows:

i) Belarus

The principal incentives are contained in the Foreign Investment Law. Qualifying enterprises receive a tax holiday (full profit exemption) for three years, and in some cases, a 50% profit exemption for an additional three years. In order to qualify, the enterprise must be engaged in production, and must be at least 30% foreign-owned. Since April 2002, domestic investors receive no special privileges (other than tax reductions for employing a certain percentage of disabled workers or Afghan war veterans).

Three free economic zones have been created. FEZ enterprises enjoy a reduced (25% or lower) effective CIT rate, and profits from some activities are entirely exempt.

ii) Ukraine

The Ukrainian tax system, and especially its policy towards investment incentives, has gone through a series of twists and turns. In 1993 tax holidays (of up to five years) were introduced for qualifying foreign investment. Those tax holidays were abolished as from 1 January 1995, and in October 1997 the "grandfathering" provisions that guaranteed existing incentives were also removed. In February 1998 a special ten-year tax holiday (plus several other tax privileges) was introduced for investments exceeding $150 million in the

automobile sector: the only potential investment that qualified was one proposed by Daewoo.[27] In December 1999, new customs duty exemptions were adopted for equipment imported as part of the charter capital of foreign-invested companies. (That exemption may still be in effect, although changes in the legislation were made in 2000, when it was found that some joint ventures were abusing the privilege by importing duty-free, and re-selling, petrol and alcoholic drinks.) The present uncertainty derives in part from a ruling of the Constitutional Court, in February 2002, that all tax preferences for foreign investors were illegal.

Like most of its neighbours, Ukraine has established a number of free economic zones.[28] FEZ investors enjoy a number of tax privileges, which seem to vary from one zone to another.

iii) Slovenia

The Slovenian tax system is currently being revised to bring it in line with EU requirements, and changes in the incentives system can be expected. As from January 1994, the tax holidays that had been available to foreign investors were removed. In their place, an investment allowance was introduced, equal to 40% of amounts invested in qualifying tangible fixed assets and intangible assets. Claw-back rules apply in the case where assets are disposed of shortly after allowances are claimed. In addition, investors are allowed to allocate 10% of taxable income to a reserve to be used for future investments. The incentive is therefore profit-related, but also investment-related in that amounts allocated must be included in taxable income, after four years, where they have not been used to finance qualifying investment. Slovenia has established free trade zones and customs zones, with the usual exemptions from customs duties and VAT. In addition, there are two special economic zones, in which investors enjoy a 10% rate of CIT, a 50% investment allowance, and customs duty privileges. These preferences apply until 2010.

Table 15-9. **Investment Incentives available in Transition Countries (2001)**

	Hungary	Poland	Czech Republic	Slovak Republic	Estonia[1]	Latvia	Lithuania	Belarus	Ukraine	Slovenia
Tax holidays	X		X	X	na			X	X	
Partial profit exemption	X			X	na			X		X[2]
Preferential CIT rate					na					
Accelerated depreciation	X				na					
Investment allowance			X		na					X
Reinvestment allowance					na					
Investment tax credit	X			X	na	X				
Customs duty exemption			X	X	na	X	X		X	
Customs duty deferral					na					
VAT exemption										
VAT deferral			X							
Special zones offering:				na	na					
>customs duty exemption	X		X						X	X
>VAT exemption									X	X
>tax holiday (CIT exemption)						X	X	X	X	
>investment allowance										X
>investment tax credit		X								
>other tax exemptions						X				X

Note: Table reports incentives available for new investment (ignores "grandfathering" provisions)
1. As Estonia no longer imposes a corporate income tax (instead a distribution tax) or customs duties, tax incentives related to these do not apply.
2: Partial CIT exemption conditional on investment expenditure

NOTES

1. The bare figures probably understate the importance of FDI in the region. For example, the amount of FDI in Romanian manufacturing (around $2 mill.) would not suggest that foreign affiliates account for 38% of all manufacturing sales and 44% of exports. The reason seems to be that assets and firms in Romania are relatively cheap and a small investment, in monetary terms, may acquire substantial productive capacity. See Hunya at p.7.

2. The comparisons exclude Russia, given an interest in focusing on countries of roughly comparable size. Armenia, Azerbaijan and Georgia are also excluded (these countries may present less competition to the SEE countries as compared with the countries included in Table 15.4).

3. "Hungarian advantage crumbling", N*epszabadszag*, March 27, 2002.

4. According to the EBRD T*ransition* R*eport* 2001.

5. The Slovak Republic was admitted to OECD membership in 2000.

6. No "score" is available for Belarus,although a "very high level" of black market activity is reported.

7. On the World Investment Report inward FDI index, Slovenia ranks lower than any of the SEE countries.

8. Economist Intelligence Unit, as reported in the Heritage Foundation I*ndex of* E*conomic* F*reedom* 2001.

9. The present Croatian corporate tax system came into effect in 2001. The previous system was unique, being described by some as a business consumption-type tax, or a form of cash-flow tax. By allowing a deduction for "interest" imputed to corporate equity, the tax base was substantially narrower than under more conventional systems.

10. An investment allowance may be restricted to some percentage (under 100%) of qualifying investment expenditures – but the amount of allowance earned may or may not be capped to some percentage (under 100%) of taxable profit (measured before the allowance). Without such a cap, the allowance may eliminate taxable profit, or if large enough relative to profit, create a tax loss (i.e. a loss that can be carried forward for tax purposes).

11. For further detail, see Deak and Krever.

12. Note that for the purpose of a cross-country comparison of corporate tax rates, Table 10 reports the 18% Hungarian tax rate on retained earnings. This rate, combined with the applicable treaty withholding tax rate on direct dividends, determines the amount of host country tax imposed on a cross-border distribution (e.g. to a foreign parent). Similarly, the rates shown for the other countries are the applicable rates, excluding non-resident withholding tax.

13. This appears to be part of the "benchmark" tax system, rather than a special investment incentive.

14. See Lehis. There have been suggestions that the Estonian CIT system is inconsistent with EU rules: See "Estonian income tax provision problematic for European Union", Financial Times, 8 March 2002 [2002 WTD 47-15]. However, it is difficult to see how the system is contrary to either the state aid rules or the code of conduct.

15. Originally, the distribution tax did not apply to payments to resident companies: that was later changed, and the recipient company is now subject to the tax, for which it receives a credit.

16. The interaction of the new system with the provisions of tax treaties, especially those with Estonia's Baltic neighbours, has caused problems, leading to the re-negotiation of the Estonia-Latvia treaty: see Uustalu (2001).

17. And Estonia where the zero rate makes loss relief irrelevant.

18. For a review of incentive policies in central Europe, from 1988-1997, see Easson (1998a).

19. In two of the zones the period was restricted to eight years.

20. The qualifying threshold is relatively low. Full exemption is given for investment exceeding EUR 2m., or less in some of the more remote regions.

21. The credit is limited to 40% in the Krakow zone. For small and medium-sized investors, the credit is increased to 65% and 55% respectively.

22. This is no longer conditional on making a certain proportion of export sales.

23. The investment need not be in the company paying the dividend.

24. The threshold is lower in regions of high unemployment.

25. Establishment of an SEZ enterprise requires government approval. This is apparently restricted to firms producing for export.

26. Larger investments qualify for full exemption for five years, with a further ten years at half rate.

27. The legality of the Daewoo law was challenged by the EU as being contrary to WTO rules and to the EC/Ukraine Interim Trade Agreement.

28. There seem to be 15 such zones, although not all of them are operational.

Chapter 16.

MAIN FINDINGS AND POLICY OPTIONS

This chapter summarises the main findings of the project, concentrating first on evidence on the determinants of FDI in SEE countries, and the relative importance of tax considerations. While taxation tends not to be a determinative factor in location decisions for investment, where it has been a factor in the SEE region, it has for the most part contributed to – rather than helped alleviate the effects of – investor perceptions of significant risk. Looking forward, development in the tax area should concentrate on addressing provisions and practices found to be impeding investment, while providing competitive and transparent tax treatment. At the same time, SEE countries are encouraged to consider the adoption of measures to protect the domestic tax base from aggressive tax planning. This recognises the scope for SEE countries to collect a reasonable share of tax revenue on inbound investment that foreign investors would view as easily managed.

Even with special incentives, and often on account of them, tax systems may be viewed as imposing excessive burdens on investors, depending on their design and administration, tending to deter investment. The second section in this chapter reviews lessons learned on particular aspects of SEE tax systems that are attractive, and aspects that have likely deterred FDI. Guidance is offered in a number of areas on what options might be considered to alleviate identified tax-related burdens. While instability in the tax area has largely contributed to risk perceptions, in some countries more than in others, on balance investors could be expected to welcome adjustments that lower impediments on the tax side. Further efforts to improve transparency and streamline administration would also be welcome.

The third section considers the use of tax incentives and, based on the evidence, identifies those that should be avoided, compared with approaches that provide attractive treatment while holding out advantages – mainly stemming tax revenues losses – for the host country.

A. The FDI Environment

The various evidence examined in this report, including the comparisons drawn in the preceding chapter, lead to the following observations and general conclusions:

- The transition countries have experienced fairly steady growth in inward FDI as they implement market reforms. Taking the four central European countries plus the three Baltic countries, the flow of FDI in the year 2001 was almost four times that of 1993. By contrast, countries such as Belarus and Ukraine, which have been much slower in instituting market reforms, have experienced very little growth in FDI. This suggests that, providing economic and political conditions are stable and received positively by investors, the SEE countries can expect FDI to increase as they continue to implement reforms.
- There is a close link in many transition countries between FDI and the privatisation process: that is, a substantial proportion of FDI has taken the form of acquisitions of shares in state-owned enterprises. This accounts in part for the unevenness of FDI in some countries.[1] Progress in privatisation is consequently likely to produce increased FDI. The downside is that once privatisation is completed, investor interest may fall significantly. In Hungary, FDI has declined steadily since 1995 (with a notable reversal in this trend in 2001); in the Czech Republic it peaked in 1999. In Poland, FDI declined in 2001 from its all-time high in 2000: only 6% of FDI was derived from privatisation in 2001,

compared to 35% in the previous year. The indications, therefore, are that FDI in transition countries may decline, perhaps substantially, once the process of privatisation is completed, unless a major effort is made in the right areas to provide an "enabling environment" for greenfield investment.

- Non-transparent policies and administrative practices have contributed considerably to investment costs in SEE countries. The need to allocate significant human resources to understand and comply with non-transparent tax policies and administrative approaches, by increasing project costs, has tended to discourage initial investor interest and scope for continued commitment. Similar cases have been found in other transition economies, where there is considerable survey evidence that non-transparent and often inconsistent government policies and obstructive or incompetent bureaucracies are major irritants and deterrents to FDI.
- One of the most important determinants of FDI in SEE countries – and very often the most important – is the risk factor. Investments in SEE countries are typically made on the presumption of an attractive business opportunity, but accompanied by a high perceived-level of risk. In some countries, especially those that have experienced great difficulty attracting substantial FDI, there are frequent complaints of uncertainty over applicable tax policies and tax administration and thus uncertainty over the implications of tax on profit. A patchwork of changing policies and practices in some countries has heightened uncertainty and perceived levels of project risk, tending to curb investor interest.
- Closely related to project costs and risks are real and perceived levels of corruption of tax and customs officials. Contending with corruption increases project costs, while uncertainties associated with the frequency, degree and cost of corruption add to project risk. Corruption, by increasing project costs and risks, operates through these channels to reduce expected risk-adjusted rates of return, discouraging greenfield FDI.
- SEE countries seeking to attract greenfield FDI should concentrate their efforts on the implementation of sound economic reforms that focus on providing basic elements of an enabling environment. Tax and supporting administrative practices should be clarified through budget documents, explanatory notes and public statements. Independent and fair evaluations of major programmes (e.g. tax expenditure programmes) should be undertaken, and audited public accounts should be prepared annually, with unfettered public access to such information.[2]

B. Tax Systems

While certain surveys find that investors take tax factors into account when examining potential host countries,[3] there appears to be little (if any) correlation between a country's overall performance in attracting FDI and its overall tax level or overall corporate tax burden.[4] That is so whether one examines FDI flows into transition economies (as in Chapter 15), or worldwide flows (as in Chapter 1). Obviously other non-tax factors are more important. A favourable tax climate, by itself, will rarely if ever be sufficient to attract investment.[5] This view is consistent with a proper assessment of what drives investments motivated by location-specific profit.[6]

Nevertheless, a country's tax system, and in particular its corporate tax system, tends to be taken into consideration by most potential investors, particularly where a country is short-listed as a possible location for investment. Therefore, any country that seeks to attract FDI should attempt to ensure that its tax system and tax burden do not constitute a deterrent. The following factors would seem to be particularly relevant, concentrating first and primarily on corporate income tax (CIT) issues.

1. *The Corporate Income Tax System*

A country's choice of basic corporate income tax system – classical, full or partial imputation, or some other variant – seems to have relatively little importance to investors, provided that the system and its main features do not differ radically from international norms.[7] More important is the effective host country tax burden, the scope to "manage" that tax burden (taking into account the interaction of host and home-country tax systems and tax-planning opportunities), and the predictability of host country tax treatment over time.

Most of the SEE (and other transition) countries have opted for variants of the classical system, often with a final flat rate withholding tax on dividends to resident individual shareholders. This type of system has the advantage of simplicity and relative ease of administration. At the same time, by collecting tax at the company level on profits distribution to shareholders, scope for non-reporting of investment income by resident shareholders is reduced, which in turn helps to shore up tax revenues to finance government programmes furthering the developing of necessary "enabling conditions" (e.g. infrastructure development). As noted in Chapter 15, FYR Macedonia and Serbia tax dividends paid to resident shareholders at the personal level. Where an analysis of corporate and personal tax returns suggests that distributed domestic profit tends not to be reported at the personal level, consideration should be given to eliminating shareholder-level taxation, possibly with greater reliance on taxation at source.[8]

In principle, a classical system imposing corporate and shareholder tax on distributed profit offers an additional feature that is attractive as regards foreign investment, as the effective corporate tax rate can be lower than that under an equal-yield integrated system. As noted, the classical system variants in most SEE countries rely on final withholding tax at source as a means to collect additional revenue on profit distributed to shareholders (i.e. in addition to corporate tax imposed on the distributed profit). In contrast, relatively little tax revenue may be collected from shareholders by an integrated system which imposes tax at the personal level on dividends, but provides imputation or dividend tax credits to relieve double taxation.[9] Therefore, with relatively more tax revenue collected (in principle) from domestic shareholders under a classical system, the tax take at the corporate level may be lower for a given amount of combined (corporate and shareholder) tax. In other words, in effect, a classical tax system shifts part of the tax burden from the company to resident individual shareholders. The Hungarian system, with its relatively low corporate tax rate and a comparatively high withholding tax on dividends, is a good example of this.

Two systems for taxing capital income described briefly in Chapter 15 stand out as alternative approaches. The Croatian system in force prior to 2001, which had features of the "ACE" system proposed some years ago by the Institute of Fiscal Studies,[10] would seem to be attractive to investors, largely because of its low effective corporate tax rate. And it is true that Croatia was relatively successful in attracting FDI during the period when that system was in force. However, this system was replaced by a more conventional approach, as from 2001.[11] A possible disadvantage with the earlier Croatian system was that the nominal CIT rate was relatively high, to compensate for the much reduced tax base. The high rate may have been counterproductive to the extent that potential investors, when compiling a short list of possible locations, are influenced mostly by the nominal CIT rate, rather than by the effective rate (on which little information may be readily available).

The other system to note is that of Estonia. Academics and practitioners have long discussed the question of whether company profits should be taxed. Estonia is perhaps the only transition economy to have actually abolished its corporate income tax,[12] while similar proposals to do so have been made in Bulgaria and Lithuania. There is an appealing simplicity about the Estonian system, which effectively exempts from tax profits that are retained in the company, while taxing distributions under a uniform distribution tax (with the same withholding tax rate applied to resident and non-resident shareholders).[13] Such a system would also seem to provide a strong incentive to reinvest. However, as with any relatively untried system, there are problems: for example, how to treat personal holding companies and how to define "distribution" to ensure that some types of return on equity do not escape tax entirely.

While classical tax systems offer certain advantages, it is important that the design not operate to discourage vertical corporate structures, as can occur where dividends passing along a corporate chain attract multiple layers of taxation. Where taxation at source is final, as in the case of Romania, this problem generally does not arise. In Albania, the problem is addressed by waiving withholding tax at source on distributions to related companies, while imposing tax when profits are distributed to individual shareholders. Bulgaria and FYR Macedonia may wish to consider imposing withholding tax on distributions to unrelated resident corporations if tax return information reveals that individuals are using domestic holding (intermediary) companies to avoid personal tax on dividend income.

2. The Statutory CIT Rate

The nominal or "headline" statutory corporate income tax (CIT) rate is typically the most important tax parameter in the eyes of foreign investors. This was certainly confirmed in the survey of SEE investors – where taxation was taken into account in short-listed countries for greenfield investment, the statutory CIT was typically the key tax factor. However, a low statutory CIT rate will not be viewed as attractive where closer examination reveals it is applied to a tax base that is inconsistent with international norms. While recent empirical work finds that real FDI is becoming increasingly sensitive to host country taxation, a low statutory corporate tax rate (or more generally a low effective corporate tax burden) by itself is not sufficient to attract FDI: other enabling conditions outside the tax area are more important to investors.

At the same time, it seems likely that an unusually high statutory corporate tax rate could deter investment, while the performance of Hong Kong and of Ireland suggest that unusually low rates will tend to be a central feature in attracting it, at least for mobile financial and production activities (e.g. microchip production).[14] This potential role of the CIT rate tends, however, to be conditional on success in having introduced public programmes and policies that have supported the development of "enabling conditions" identified first and foremost as key to attracting and retaining FDI.

The statutory CIT rates currently in force in the SEE countries, in the range of 15% to 25%, are already moderate or low by international standards. Short of introducing an Estonian-type system that abolishes corporate income tax, there would seem to be little to gain, in terms of increased FDI flows, from further reductions in statutory CIT rates. Rather, SEE countries would be advised to avoid this form of tax competition, and concentrate on improving other aspects of their tax systems with the aim of improving transparency and predictability of tax rules and regulations, easing taxpayer compliance, and collecting a reasonable share of host country tax from foreign investors.

3. The Tax Base

The rules governing inclusions in and deductions from taxable income seem to be generally consistent with international practice in most of the SEE countries, as outlined in Part II. However, depreciation regimes are in some cases unnecessarily complicated, and not always generous (as elaborated below). Furthermore, loss carry forward provisions are restrictive in many cases relative to international norms (also elaborated below). In addition to these impediments, a few of the countries have questionable restrictions on deductible expenses, which may be an irritant to foreign investors, although in practice the effect of these rules may be circumvented.

In most SEE countries, taxable income is derived from book (accounting) income as measured for financial reporting purposes. In principle, relying on book income offers the advantage of providing an unbiased profit measure that reflects nationally agreed accounting standards. Such a measure can then be adjusted, as necessary, to reflect tax as opposed to accounting principles (e.g. by netting out certain inter-corporate dividends to avoid double taxation of domestic profit, the use of tax rather than book depreciation).

Yet, in practice this basis may be problematic and lead to significant tax base erosion, possible market distortions and other problems, where accounting profit measures do not give an unbiased and accurate account of revenues and costs. This situation can occur, for example, where underlying principles or rules guiding the measurement of accounting profit are non-existent or weak, or the administration of such rules is subject to abuse including corruption (e.g. bribes to accountants and/or public officials to endorse incorrect accounts). Therefore, when relying on book income as a basis for measuring taxable income, all countries should attempt to ensure that standards for proper, transparent accounting of book income are established, understood and followed.

Unfortunately, this approach is not always observed in developed, developing and transition economies alike. In the context of the SEE countries relatively new to market reform, where the development of institutional frameworks providing effective oversight and enforcement of agreed accounting standards is at a formative

stage, tax officials are encouraged to work closely with other relevant bodies to ensure that financial reporting provides a fair basis for the measurement of taxable income.

4. Depreciation Allowances

For all countries with an income tax system, a key consideration is the treatment of the cost of depreciable capital in measuring taxable income.[15] Indeed, the rules over the treatment of depreciable capital costs for tax purposes are a central structural element of a corporate income tax. Depending on the tax treatment provided, firms may be able (or not) to recover their investment costs. Where tax allowances are restrictive, the effective tax rate on investor profits can exceed the statutory corporate tax rate, perhaps significantly, tending to discourage FDI. The impediment is compounded where the depreciation system is excessively complex or unstable, adding to project (compliance) costs and risks.

Depreciation expenses are particularly important for large, capital-intensive firms. Given that their treatment determines in large part the cost of capital, it is paradoxical that a number of SEE countries have depreciation rules that are discouraging to FDI, while at the same time offer an array of fiscal incentives aimed at attracting FDI. It would seem to make a great deal of sense to first ensure that the basic tax treatment of capital costs has been properly addressed. Moreover, a considerable degree of flexibility exists within a basic depreciation system to provide generous relief in respect of capital costs, operating to encourage investment. Such an approach holds out certain advantages.

A review of the depreciation allowance systems in SEE countries finds a diversity of approaches. Some systems appear overly complex, relying on an excessive number of depreciable asset categories, depreciation methods and rates. Discussions with Serbian tax officials, for example, have indicated that their country's system will be subject to a major review, beginning with consideration of a simplified depreciable asset classification scheme. As argued in Chapter 2, countries in the early stages of developing their corporate tax systems are well advised to adhere to a relatively simple depreciation system that would rely on a small number of depreciable asset categories (e.g. five to six or fewer).

The country chapters in Part II of the report point to the fact that most SEE countries continue to rely on the straight-line depreciation method for depreciating machinery and equipment. Considerations raised in Chapter 2 argue in favour of the declining-balance method instead for most depreciable asset classes, which offers a number of advantages over alternatives (e.g. pooling of assets, treatment of capital gains, losses and depreciation recapture, and "front-end" loading of tax relief). On the basis of these considerations, increased reliance on the declining-balance method would appear to be in order.

Furthermore, the majority of systems may be seen as restrictive, requiring (mandatory) depreciation claims in each year regardless of the firm's profit position (rather than allowing depreciation claims to be carried forward). While restrictive, mandatory claims offer simplification, as taxpayers generally are not required to maintain balances (pools) of undepreciated capital costs. However, this approach is onerous and therefore problematic where loss treatment is restrictive. As discussed below, where depreciation claims are mandatory, the interaction between depreciation rules and business loss carry-forward rules is critically important, and may need to be re-examined.

Closely tied to the assignment of recovery periods to assets, and the choice of depreciation method(s) is the system of depreciation rates and "coefficients" or scalars. Certain systems may be depreciating capital at rates that are arguably too slow, suggesting scope for reducing the after-tax cost of capital and supporting FDI through this channel. Among alternative tax measures to support FDI, depreciation rates and coefficients that accelerate depreciation – that is, apply a faster effective rate of depreciation relative to that corresponding to an estimate of the true economic depreciation rate – are arguably preferable to certain other approaches.

The shifting forward in time of allowed tax deductions under an accelerated regime is attractive, both to investors who see the present value of depreciation claims increase (and likewise their after-tax rate of return on investment), and to policy-makers. Accelerated depreciation is attractive compared to other fiscal

incentives on a number of counts. Unlike tax credits, accelerated depreciation does not create additional revenue losses, but a shifting forward in time of revenue offsets. Also, unlike tax credits, the taxpayer does not need to keep separate (additional) accounts to track unclaimed balances, as these are part of the basic depreciation system. Furthermore, unlike tax credits, accelerated depreciation generally does not favour short-lived over long-lived assets. Also, with recapture features built into depreciation systems, investors are discouraged from "churning" (selling and repurchasing) assets to obtain multiple amounts of tax relief in respect of the same asset.

Lastly, some countries have been found to provide taxpayers with an unusual amount of discretion in selecting the applicable depreciation methods, while in others excessive administrative involvement has been identified. Given the advantages of a simple, transparent tax system, such practices should be reconsidered. In short, a review of depreciation systems in SEE countries reveals a number of design features that could be usefully addressed.

5. *Loss Relief*

Apart from statutory tax rate and depreciation provisions, a central corporate tax consideration is the system providing relief for tax losses. Firms making substantial new investments in a country may be in a loss position for several years. Indeed, large capital-intensive projects may not begin to make profits for the first five years, or possibly longer. For such firms, the ability to carry forward start-up losses, to be used to reduce future taxable profits, is of the utmost importance.

As noted in Chapter 2, the international norm is to provide a minimum loss carry-forward of five to seven years, with many countries allowing a longer period. A number of SEE countries have what could be viewed as restrictive rules for loss relief (e.g. loss carry-forward limited to three years). Such restrictive rules may carry over from prior regimes, and/or may be in place to contain revenue losses associated with the privatisation of companies with large pools of accumulated losses.[16]

Also elaborated in Chapter 2, depreciation rules and loss carry-forward rules interact in important ways. The interaction becomes critically important where depreciation claims are mandatory, as they are in SEE countries. In particular, where depreciation rules require that capital cost allowances be claimed as they are earned (rather than allowing for a carry-forward of those allowances), the ability to obtain tax relief in respect of those allowances critically depends on the generosity (or lack of it) under the corporate tax system's loss carry-forward rules. Albania and FYR Macedonia, countries that restrict loss carry-forwards to three years, may wish to consider whether the restriction in place in their systems can be relaxed.

Where loss carry-forward rules are restrictive – for example, requiring that losses realised in one year must be claimed over the following three years, with any unclaimed balance at the end of that period becoming no longer available for a deduction – then even accelerated depreciation rules may be regarded, in effect, as restrictive. The interaction between a country's depreciation system and loss carry-forward rules should be examined in order to establish whether desired effects, as regards investment incentives and tax revenues, are being met. Where accelerated depreciation is being sought as a means to support FDI but existing loss carry-forward rules often operate to deny firms a reduction in tax liabilities (perhaps increasing capital costs), countries would be well advised to consider whether their loss carry-forward rules can be relaxed. This would involve assessing the costs that lifting the loss restrictions would entail, relative to the expected net benefits in terms of additional investment.

6. *Withholding Taxes*

Most of the SEE countries already have a reasonably extensive tax treaty network, including treaties with most of the principal European investor countries. A number of SEE countries, however, do not have treaties with certain major capital exporters (e.g. Japan, the U.S.). Rather than wait until a complete network of treaties is concluded with these and other major investor countries, it might be worth considering reducing statutory non-treaty rates to levels closer to treaty norms.[17]

Existing treaties generally prescribe rates of withholding tax that are consistent with international norms, although several of the SEE countries have treaties with low/no tax countries that provide for zero withholding tax on dividends, interest and/or royalties, making it possible for foreign investors to extract income free of tax to be received by finance subsidiaries located in these low/no tax treaty countries.

Zero or low/nominal withholding tax rates are potentially the most problematic where applied to deductible payments, including interest and royalties, where sufficiently robust safeguards (e.g. transfer pricing rules, thin-cap rules) are not in place to discourage tax-motivated stripping of profit from the host country tax base. Those SEE countries that have not yet introduced such safeguards should consider doing so in order to protect their tax base, shoring up badly needed tax revenues.

While the introduction of thin-capitalisation rules can be recommended for countries without such rules, an elaboration of possible variants is beyond the scope of this paper, which gives its focus to more central or "mainstream" design elements. Similarly, this paper does not cover regulatory and administrative issues in relation to transfer pricing. Nevertheless, SEE countries without thin-capitalisation rules, or with variants that have been found to be weak, should consider introducing those rules. Similarly, SEE countries should examine their rules and administrative practice covering the enforcement of arm's length prices in international transactions.

7. *Tax Base Protection Measures*

Where investors are interested in greenfield investment opportunities in SEE countries, they are typically attracted on the basis of non-tax considerations, and in particular, expectations of earning above-normal rates of return on invested capital. Given this, scope exists for SEE countries to collect a percentage of these profits in tax without discouraging investment, provided that the effective tax rate and compliance burdens are not viewed as excessively high.

Tax-planning incentives on the part of MNEs to strip out profits – for example to offshore holding and financing affiliates – are largely determined by the setting of the host country statutory corporate income tax rate. A relatively high (low) rate tends to encourage (discourage) tax-planning, a consideration which supports the choice of a competitive statutory corporate income tax rate over alternative incentive strategies. However, tax-planning incentives are at the same time a function of professional costs met in developing and defending a given tax minimisation strategy. Where base-protection rules and tax administration are perceived as weak, (minimal) tax-planning efforts are likely to be viewed as worthwhile, even where the host country statutory corporate income tax rate is relatively low.

SEE countries are therefore encouraged to review their base protection rules and the operation of those rules in practice, to determine where they can be strengthened. Relevant rules include transfer-pricing rules requiring adherence to arm's-length prices in non-arm's length cross-border transactions with affiliates. Also relevant are thin-capitalisation rules and related provisions designed to protect the base from excessive use of debt finance and deductible interest charges. While beyond the scope of the current project, aimed at assessing other core tax design and incentive questions, SEE countries without such rules should consider introducing them, while those with them should review their operation to determine if useful modifications are in order.

8. *Payroll Taxes and Social Security Contributions*

A common tax system feature of SEE countries and most transition economies, to a greater or lesser extent, is reliance on relatively high social security contribution rates. High contribution rates, especially those levied on employers, go some way to undermine the advantage to investors of gross wages that are relatively low (in relation to relatively high levels of worker productivity) by international standards. Social security contributions generally are most discouraging to FDI where they cannot be shifted onto labour through workers accepting lower gross wages (or shifted forward onto prices). This situation is most likely to arise where employer social security contribution rates are high, rigidities exist in the labour market that make

it difficult to shift these contributions onto labour, and where workers do not perceive that employer contributions will translate into personal benefits over their lifetime.

Given their budgetary importance, a substantial reduction in contribution rates may not be immediately possible. Where this is the case, it would be useful to consider labour market conditions to determine whether institutional changes might be possible to enable at least a partial shifting of employer social security contributions.[18] Other possibilities could include a gradual, partial shifting to personal income tax and VAT.

9. *Customs Duties*

Interviews with SEE investors confirm studies in other countries that find that customs duties, especially those on machinery and equipment required to establish a new venture, are often a major concern to potential investors. Rather than provide special exemptions for some investors, as is commonly done in SEE countries, consideration might be given to a general reduction or elimination of import duties still in effect on most types of machinery and equipment. Where revenue requirements make this a difficult option to implement immediately, consideration might be given to an announced gradual reduction. Steps taken towards strengthening the corporate income tax base along the lines suggested above would also help address revenue reductions on the customs side.

An exemption already applies, or will soon apply, to imports from EU countries, so that substantial duties on imports from other countries are likely to place non-EU investors at a real competitive disadvantage. This can arise where subsidiaries of non-EU companies import machinery and equipment from their parents or affiliates based outside the EU. However, it is recognised that over the medium to longer term, customs policy is likely to be determined primarily by the need to harmonise with the EU rules.

10. *Tax system considerations*

The preceding review leads to the following general observations and conclusions relevant to addressing tax impediments to FDI in SEE countries:

- In many SEE countries, non-transparent and unstable tax policies combined with non-transparent and sometimes corrupt administrative practice have contributed to project costs and heightened levels of perceived project risk, tending to discourage investment. Tax incentive programmes have tended to contribute to uncertainty and project risk, particularly where administered in a non-transparent fashion. A priority initiative should be to review tax systems (policies and administration) to improve transparency and minimise the scope for corruption.
- The “enabling environment” should include a relatively simple and easy-to-administer tax system that offers competitive host country tax treatment, with basic corporate tax rules that do not deviate significantly from international norms. Host country tax burdens should not exceed those of competing jurisdictions offering comparable enabling conditions, given the goal of attracting FDI, except where location-specific rents can be captured.
- Tax systems should be reviewed with an eye to removing impediments to FDI posed by the tax system. At the same time, it is important to recognise that significant tax relief can be delivered through the design of basic features of the tax system, such as the setting of the statutory corporate tax rate, the design of the depreciation system, and loss treatment. The adoption of measures that remove impediments, impose a relatively low, competitive corporate tax burden and enhance transparency, may operate to lower project costs while at the same time lessening the scope for corruption, reducing actual and perceived levels of risk, factors which together should operate to encourage FDI.
- Countries relying on book income as a basis for measuring taxable income should aim to ensure that standards for proper, transparent accounting of book income are established, understood and followed. Where the development of institutional frameworks providing effective oversight and enforcement of agreed accounting standards is at a formative stage, tax officials should be encouraged to work closely

with other relevant bodies to ensure that financial reporting provides a fair basis for the measurement of taxable income.

- Statutory CIT rates currently in force in the SEE countries, in the range of 15% to 25%, are already moderate or low by international standards. Efforts to improve competitiveness of tax systems should concentrate on improving basic aspects of tax systems with the aim of improving transparency, predictability, and collecting a reasonable share of host country tax from foreign investors.
- Progressive and regressive corporate tax rate systems should be reconsidered, in favour of a flat corporate tax rate structure.
- The classical tax system, which most of the SEE countries have opted with a final flat-rate withholding tax on dividends to resident individuals, is appropriate, offering the advantage of simplicity and relative ease of administration.
- Systems differ in terms of their treatment of intercorporate dividends. Multiple taxation of distributed profit paid along a chain of related corporations should be avoided, possibly by providing dividend exemptions on intercorporate dividends between related companies, with final withholding on the first payment outside a corporate group. Dividend gross-up and credit provisions at the corporate shareholder level should be avoided if found to add significantly to complexity.
- Where tax treaties do not exist with major capital exporting nations, and the conclusion of such treaties if a number of years off, countries should consider reducing statutory non-treaty rates to levels closer to treaty norms.
- Countries without thin-capitalisation rules or with variants that have been found to be weak, should consider introducing those rules. At the same time, countries should examine their rules and administrative practice covering the enforcement of arm's length prices in international transactions.
- Countries with relatively high employer social security contribution rates should consider lowering those rates to international norms as soon as possible. Where such reductions are not possible currently due to budgetary pressures, labour market conditions should be examined to determine if institutional changes (e.g. elimination of minimum wages) might be possible to enable at least a partial shifting such contributions onto employees.
- Where special customs duty exemptions are currently provided on imports of machinery and equipment for certain investors, consideration might be given to a general reduction or elimination of import duties still in effect on most types of machinery and equipment. Where revenue requirements make this a difficult option to implement immediately, consideration might be given to an announced gradual reduction.

C. Tax Incentives

As reviewed in Part II and Chapter 15, tax incentives to promote FDI are a feature of the tax systems of most of the SEE countries and transition economies, as they are in many countries around the world. Chapter 3 considered evidence and various arguments regarding the effectiveness and efficiency of such incentives. In this concluding section a few general observations may be made with particular reference to the situation of the SEE and transition countries.

1. *Effectiveness*

Relatively low levels of greenfield investment attracted to the SEE region and the investor survey findings suggest that tax incentives have largely been unsuccessful in encouraging new capital formation. Where tax incentives have influenced investment decisions, it is unlikely that additional investor activity has been of the scale required to more than offset direct and indirect revenue losses to targeted and unintended recipients. This view is based on general findings of the efficiency of tax incentives, and in full recognition of the difficulties in administering tax incentive programmes, particularly the ones observed in SEE countries, and the generally weak (and often corrupt) state of tax administration.

Furthermore, as emphasised in the survey findings, the potential for tax incentives to attract new investment depends critically on the state of progress in developing "enabling conditions", including the removal of impediments to FDI. This call carries over to the tax side, where countries are encouraged

to examine their basic tax rules to ensure that they are not viewed negatively in relation to international norms.

Croatia, the country that has been most successful in attracting FDI (on a per capita basis) provides a quite limited range of incentives, although the present incentives for large investments and for investment in the free trade zones are relatively generous. However, Croatia's comparative success in attracting FDI arguably owes more to its geographical position and its relatively advanced economy than to any tax incentives offered.

The evidence on other transition economies is rather mixed. Hungary's early success in attracting FDI may have owed something to the existence of far more generous tax incentives than those provided by its neighbours. Poland's striking growth in FDI also coincided with the introduction of an exceptionally favourable special economic zone regime, while the increase in FDI in the Czech Republic occurred around the time that new, investor-friendly policies, including special incentives, were introduced.[19]

However, there is a very close relationship between FDI flows to those countries and the pace of privatisation. The fact that investment in all three countries has tailed off as the privatisation process has completed underlines the important role that privatisation has played in driving FDI, and casts significant doubt over whether tax incentives have been a determining factor in investment flows. Furthermore, it is not clear whether a cost-benefit assessment would show that tax revenues foregone to greenfield investors under these tax incentive regimes have been more than offset by additional FDI activity.

As noted earlier in this chapter, FDI in the SEE countries has been primarily privatisation-led and, in most cases, market-oriented as opposed to export-oriented. This type of investment is less likely to be influenced by tax incentives and, in the case of privatisation, the primary determinant is likely to be the acquisition cost. There is evidence to suggest that acquisition costs have often been too low relative to the value of the assets or firms acquired,[20] and that investors receive a windfall benefit if they are additionally granted tax holidays or other tax benefits. This suggests that, if tax incentives are to be retained for some types of investment, they should not be given in the case of privatisations, or should be restricted to the contribution of new assets.

2. *Stability and Transparency*

The experience of some of the countries reviewed in the previous chapter suggests that frequent changes in incentive policy may be highly counterproductive towards FDI. The elimination of existing incentives can send out unintended signals that foreign capital is no longer welcome. The withdrawal of tax privileges that have already been granted – and possibly factored into investment plans – can have an even worse effect, destroying the credibility of the host government and significantly raising investors' perception of risk. Even the replacement of one set of incentives by another can create an adverse impression by adding to compliance costs and perceived risks, especially if done frequently. At the same time, such changes create transitional problems in relation to the treatment of those enterprises that are already enjoying privileges that are about to be replaced.

These considerations, of course, do not mean that poorly designed and ineffective tax incentives should not be replaced. What it does mean is that care must be taken to get the tax and incentive package "right", and to ensure that the transitional arrangements will be viewed as satisfactory.

Closely related to the issue of stability is transparency. In general, tax incentives and tax systems should aim to be as transparent as possible, both in terms of the manner in which the relevant laws and regulations operate and interact, and in terms of how they are administered.[21] Providing transparency provides investors with information that can be used to plan operations, assess and minimise project costs and risks, and forecast profits. A lack of transparency adds to project costs and risks, tending to discourage investment. As noted, stability in rules can operate to encourage investment by reducing compliance costs and perceived risks, even where the effect of the rules themselves add to project costs (with the proviso that the rationale

behind the rules is explained and can be justified). However, regardless of the degree of stability, transparency should be sought in order to minimise (and not contribute to) costs and risks associated with a regime or regime change. Finally, transparency is all-important in ensuring recognition and use of incentive policies, which clearly is important where incentives are judged useful and a significant uptake is desired.

3. Incentive Choice and Design

A number of tax incentive design issues and considerations were raised in Chapters 2 through 6, and those discussions need not be repeated here.[22] The survey and analysis of the SEE tax incentives systems, and the comparisons made in the previous chapter, lead to the following observations:

- Tax holidays are an especially inefficient form of tax incentive, being the most open to tax planning. Unlike incentives earned as a percentage of investment (which cap revenue losses to some fraction of qualifying expenditures), tax holiday relief is not limited in this way to the desired activity. Instead, all returns over the holiday period on investment – including returns covering initial investment costs as well as normal and "super-normal" profits – are earned tax-free. Providing this level of tax relief on targeted profits – as well as on profits of related, non-qualifying firms transferred to tax holiday firms using non-arm's length pricing and financing arrangements – should be seen as excessive. Also, contrary to certain views, tax holidays offer limited "simplification" opportunities (e.g. where taxpayers must maintain taxpayer accounts to support tax calculations over the post-holiday period).
- Partial profit exemptions are also an inefficient form of incentive, as they provide, like tax holidays, similar tax-planning opportunities and tax relief not tied to investment, albeit on a reduced scale (proportionate to the percentage relief offered). Like tax holidays, partial profit exemptions are unlikely to create an efficient result, with opportunities for tax-planning and corresponding revenue losses outstripping benefits.
- Reinvestment allowances, providing a tax deduction equal to some percentage of (pre-tax) profit that is reinvested, are of questionable use as a means to spur investment. While retained earnings may be the most common source of finance (and the cheapest source in most cases), it is unclear why a special tax preference should exist for investment financed by retained earnings. Viewed another way, the rationale for discriminating against investment financed by new share issue or debt is not clear. If incentives tied directly to investment are desired, it would seem preferable to rely on provisions that provide relief in respect of investment expenditures without regard to the specific sources of finance. Reinvestment allowances also require rules to track the use of retained earnings, adding complexity to the system. Finally, reinvestment allowances and similar incentives introduce a circularity in optimal investment and tax minimising calculations, which if not followed may result in the tax relief being used to increase dividends rather than investment.[23] One of the observed responses by government to this problem has been to introduce special rules that require that taxpayers not use tax relief from reinvestment allowances to increase their dividend payout.
- Accelerated depreciation may be an attractive option, but will be of limited interest to investors if the basic capital cost allowance system is complex and/or restrictive (e.g. mandatory depreciation claims combined with limited loss carry-forward rules). However, general accelerated depreciation applied to a streamlined system of capital cost allowance categories, when combined with five to seven year loss carry-forward rules, offers a relatively simple and efficient means to encourage investment (as elaborated in the preceding section).
- Investment tax credits and allowances may be abused by taxpayers (e.g. "churning" of qualifying assets to enable multiple access to tax relief), require separate special accounts to track unclaimed balances,[24] and may distort investor choice towards short-lived assets. However, investment tax credits and allowances provide a relatively flexible mechanism for targeting tax relief to specific types of investment expenditure above and beyond that provided through depreciation, for example, capital used in targeted areas or business activities. They also provide a means to limit the amount of revenue loss by limiting the amount of credit/allowance earned to some fraction of qualifying investment; by possibly limiting the amount of credit to some fraction of (pre-credit) tax payable, or limiting the amount of allowance to some fraction of (pre-allowance) taxable income.

- Countries should avoid excessive "stacking" of CIT incentives. Offering multiple CIT incentives may be counterproductive as it tends to increase complexity, contributing to compliance and administrative costs[25]; can create unintended patterns of tax relief across different taxpayers and asset types, leading to inefficiencies; and it can create an impression that the country does not have basic "enabling conditions" necessary for profit-making in the host country and is attempting to rely on an "easy fix". In extreme cases, can cast doubt over the fiscal position of the country, and contribute to concerns over sovereign risk.
- Investment "incentives" may, in effect, be realised by addressing impediments in the tax system, (i.e. simplifying tax calculations and lowering tax rates on business where possible, taking into account overall fiscal requirements and the incidence of alternative tax bases). Examples could include the use of a single (rather than multiple) corporate tax rate structure; streamlining complex capital cost allowance systems; liberalising restrictive loss carry-forward rules; increased reliance on (withholding) taxation at source; lowering employer social security contribution rates (offset possibly by increased VAT or PIT rates).
- Customs duties on imported machinery and equipment which constitute a major obstacle to foreign investment should be eliminated or lowered for all investors, if necessary under a phased-in schedule, and where possible on a co-ordinated basis (e.g. as part of preparations for EU integration).
- Special "zones" relieving profit-related taxes (e.g. corporate income tax, withholding tax) tend to attract highly mobile labour-intensive activities (as opposed to long-term capital intensive ones). Incremental investment will be low where zones largely cause capital to be diverted from elsewhere in the country. Also, as rights to operate from a special zone tend to be granted by officials on a discretionary basis (like tax holidays), they invite rent-seeking behaviour and weaken efforts aimed at routing corruption.
- The provision of tax incentive relief (whatever its form) should be as "automatic" as possible. In general, this requires that the qualifying criteria be stipulated clearly in accessible laws and regulations.[26] At the same time, even with the best drafting and full transparency, it is difficult to remove tax administrators from "borderline cases". However, scope for corruption and rent seeking tends to escalate with the degree of discretion given to tax officials in granting relief.[27] Delivery mechanisms that foster corruption frustrate wider efforts to contain corruption, distort investment patterns by subsidising projects that are not in the public interest (e.g. not of the type that the supporting legislation was meant to target), and discourage investors who perceive corruption as a major problem and deterrent to investing in the host country.
- A critical but sometimes overlooked issue, when considering alternative tax incentive designs, concerns tax administration and the need to provide a "workable" set of rules and regulations that are understandable to tax administrators, and not just taxpayers. Tax incentive design should avoid overly complicated provisions to the extent that the tax administration is inexperienced, or otherwise weak. Tax incentive delivery can fall short of expectations if a competent and fair administration to implement the rules is lacking. In a number of transition countries, investor complaints focus far more on the administration than on the actual incentive rules. Thus, when designing tax incentives, a fair assessment of the capacity of the tax administration is in order. At the same time, efforts to improve tax administration in all areas, including incentive programmes, should be ongoing. Programs, assisted by the EU and other bodies, already exist in several of the SEE countries for training officials and improving their tax administration more generally.

4. *Targeting of Incentives*

A further issue is "which (if any) investors and investment projects (or project-types) should receive special tax privileges?" Targeting is a multi-dimensional issue, with possibilities including targeting by type of investor, size of investment, type of business activity or factor input, and location or region. Again, a number of general observations may be drawn:

- Targeting incentives specifically to foreign investors create distortions to the extent that foreign investors favour certain sectors or business activities over others. Such targeting is also open to tax planning (with domestic investors disguising themselves as foreign in order to access the targeted tax relief (e.g. by investing through offshore holding companies). It can also foster domestic taxpayer

resentment of foreign capital and apathy or resentment of the domestic tax system, tending to discourage voluntary compliance and feed the black market.[28] Targeting foreign investors may also run counter to national treatment obligations (e.g. under WTO and/or EU law).

- Targeting incentives to new investment projects attempts to limit relief to new capital. However, qualifying new investment may not be incremental (i.e. would occur in the absence of special tax relief). Targeting tax relief to new investment also creates windfall losses on existing capital (declines in share values), leading to criticisms that such policies are unfair. In an effort to obtain tax relief, investors will attempt to recharacterise "old" (existing) capital as "new" (e.g. through selling a domestic company to an offshore holding company, which then reinvests the capital back in the host country), increasing revenue losses and implying an inefficient use of resources.
- Targeting by size of investment creates distortions in the choice of firm size and the organisation of business activities, resulting in inefficiencies. An exception may be drawn if market failure is resulting in under-investment in small firms.[29] However, it is important that one assess whether small firms are being denied capital for reasons of market failure, or as a result of the normal and proper functioning of credit and equity markets. If instances of true market failure tend to be the exception rather than the rule, such targeting should be discouraged, given the inability of government to target incentives to the former group alone. Where small firms are targeted, rules should be introduced to discourage large firms from dividing assets across new companies so as to qualify for relief.
- Targeting by business activity, in general, should be discouraged, in particular where it is unclear why government would have better information than the private sector in determining which activities/sectors are likely to be more profitable than others (picking "winners"), and on this basis should be subsidised. Exceptions may be drawn however in cases involving market failure. Classic cases include investment in R&D, and environmental protection, where the private sector may under-invest, failing to take into account social "spillover" benefits.[30] However, even in these areas, it remains necessary to administer certain "grey" areas (e.g. subsidising pure research versus other forms of research versus development). Difficulties in assessing the degree of market failure suggest that incentive relief should be moderate.
- Targeting incentives to underdeveloped regions may be called for to address market failures inhibiting investment.[31] However, regional-based incentives have rarely been found to be efficient in encouraging FDI. Where programmes have failed, it is normally because of a lack of "enabling conditions", and an inability of incentives to create a critical mass of activity that would generate these conditions. Where regional incentives are used to promote activity, despite efficiency concerns, the incentives should be carefully targeted to investment in well-specified areas, and monitored on a frequent basis to assess results. Sunset provisions in general should apply (see below), and/or continuation of incentives should depend on results.
- Targeting by type of finance (e.g. retained earnings) will create distortions in capital markets and should be avoided. If the objective is to encourage investment, it would be more efficient to target investment expenditures directly (without regard to how they are financed). If the tax system is creating distortions towards excessive levels of debt finance, consideration should be given to introducing/strengthening thin-capitalisation rules.[32]
- Targeting incentives to apply for a fixed period to temporarily boost economic growth runs a risk of mistiming (aggravating rather attenuating a business cycle).[33] However, announcing and immediately implementing targeted incentives to apply for a short period (e.g. one to two years) may shift forward investment that would have otherwise been delayed. Furthermore, in general all incentives should be introduced with a sunset clause stipulating that a given incentive will expire at a certain date (which may then be extended, conditional on a positive evaluation of past effects).
- For SEE countries working towards membership of the EU, in the longer term their tax incentives will have to be consistent with the state aid rules and, consequently, it seems advisable to avoid incentives of such a duration or type that they will have to be dismantled on eventual accession.
- Whatever the form of targeting, the benefits in terms of avoiding tax relief to unintended recipients must be weighed against the additional administrative costs in monitoring the programme, defending boundaries under pressure, and implementing measures to address tax abuse.
- Finally, excessive discretion in the targeting of incentives, by contributing to a lack of transparency, invites corruption and increases perceived risks, thereby discouraging investment across all (targeted and non-targeted) activities. Thus, as with the provision of incentives themselves, the process of

identifying qualifying activities should be as "automatic" as possible, through careful drafting of the applicable tax laws and regulations.

The preceding considerations point to the relative advantages of a relatively simple tax system offering a competitive statutory corporate income tax rate, accelerated depreciation with flexible loss carry-forward rules, and possibly targeted investment tax credits or allowances with rules to discourage asset churning.[34] Given that a simple CIT system can deliver a low effective host country tax burden, in particular when combined with relatively low non-resident withholding tax rates – while avoiding compliance and administration costs associated with complex and possibly redundant provisions – countries are well advised to question the merit of additional fiscal incentives to enrich the tax pot.

The temptation for SEE countries to offer a list of special incentives is understandable, given fierce competition for FDI and the availability of a wide range of tax incentives in competing jurisdictions. However, SEE countries are well-advised to seriously reflect on the merits of adhering to a structurally sound system capable of generating tax revenues to help finance public expenditures (e.g. infrastructure development in support of an "enabling environment"), taking into account country experiences and considerations raised in this report.

NOTES

1. To take an extreme example, the foreign investment in the Macedonian telecom company almost equalled the total FDI for the previous 10 years. Hungary's record year for FDI, 1995, was also the record year for privatisation receipts. In Lithuania's record year, 1998, more than half of all FDI receipts came from the privatisation of its telecom company, and substantial sums were also derived from the privatisation of most of its oil industry. A recent study of FDI in the SEE countries described it as being "privatization driven": Hunya at p.3.

2. Additionally, the following measures might be considered: establishing an effective investment promotion agency (for further details and recommendations for establishing and operating investment promotion agencies, see OECD (2001b)); introducing a one-stop approval and licensing system; and ensuring that all decisions concerning investment (e.g. approvals and incentives granted) are promptly published in a readily available form.

3. See Chapter 1, section D.

4. The ability of certain high-tax countries (i.e. countries with a relatively high total tax-to-GDP ratio, or high corporate tax-to-GDP ratio) to attract significant levels of FDI can be explained in part by the fact that tax revenues finance infrastructure development (e.g. highways/airports to access input/output markets), and education and training, which in turn contribute to corporate profit.

5. This can be said even of classical tax havens. With many jurisdictions offering complete tax exemption, emerging tax havens are pressed to offer stable legal and regulatory regimes, or more generally an enabling environment that secures a predictable outcome, in order to attract mobile financial services.

6. When considering location-specific rents, the key criterion is the after-tax rate of return and whether this return (after factoring in all taxes) exceeds the required rate of return on the firm's real physical capital.

7. For a review of different CIT systems, especially in an international context, see Head and Krever.

8. Macedonia's withholding tax rate on dividends paid to resident shareholders, at 7.5%, falls within the range observed in other SEE countries (e.g. Albania: 10%, Bulgaria: 15%; Romania: 5%; Serbia: 10% (effective rate)). However, its statutory corporate tax rate at 15% is relatively low (and possibly could be increased). In Serbia, the 10% effective withholding tax rate, and 20% statutory corporate income tax rate, are attractive. If these rates are to

remain unchanged and personal tax on dividend income is eliminated, the tax revenue loss (which may be small if this income tends not to be reported) could possibly be addressed through a broadening of the tax base (e.g. through the elimination of certain targeted investment incentives).

9. More precisely, a greater amount of tax revenue is collected upon the distribution of a currency unit of after-corporate tax profit by a final withholding tax imposed at rate tp as compared with a personal income tax that imposes tax at the shareholder-level at the (same) rate tp but then provides an imputation or dividend tax credit in respect of dividend income.

10. See IFS (1991); Gammie (1992).

11. For a critique of the change, see Zgombic.

12. As opposed to tax havens, and some other countries that have never taxed income.

13. The distribution tax rate is roughly 35%. Additionally, non-resident shareholders are subject to non-resident withholding tax (unless the non-resident is a direct shareholder holding at least 25% of the share capital or votes in the distributing company).

14. No or nominal tax rates in tax havens, when combined with a lack of exchange of information between host and home countries, may be very effective in attracting mobile financial services and related services activities. However these activities are not the focus of the present study which concentrates on FDI in business activities managing primarily real investment capital (i.e. machinery and equipment, buildings). Note also that the Irish 10% rate on manufacturing profits, in place through to 2002, is not the "standard" rate and it seems more appropriate to consider it as a special incentive The 10% manufacturing rate is being replaced by a standard (general) corporate tax rate of 12.5% for 2003 and thereafter.

15. Each of the SEE countries participating in this report have adopted income-based tax systems (rather than business cash flow models), requiring a deduction for depreciation properly measure (economic) income.

16. For example, where state-owned companies are privatised and purchasers are able to apply accumulated losses of those companies to shelter from tax unrelated income, it may be in the interest of the host country to have in place restrictive loss carryover rules. This interest would generally heighten during period of large-scale privatisation if accumulated losses are significant, and restrictions are not in place to ring-fence those losses. Where this has been a problem, countries may wish to reconsider extending the number of years that losses may be carried over for tax purposes, once the process of privatisation is largely complete and accumulated losses have been purged from the system.

17. Some would question whether a high statutory withholding rate gives significantly increased bargaining power in treaty negotiations.

18. Institutional factors that could operate to prevent or discourage tax shifting include a binding minimum wage, and relatively large/strong unions (organised labour) that can effectively resist gross wage reductions. Countries may wish to consider the Dutch approach of including employer social security contributions in personal taxable income, to the extent that this could allow reduced employer social security contribution rates (e.g. where social security benefits are funded in part by general tax revenues).

19. There is a tendency, especially in the Czech Republic, to attribute almost all new foreign investment to the existence of tax incentives: see, for example, "CzechInvest attracts FDI worth a record $2 bn. to CR last year", CTK B*usiness* N*ews*, January 7, 2002. However, a recent study shows that only 20% of foreign investors actually received tax incentives: "Incentives important for 20% of investors in CR only", CTK B*usiness* N*ews*, May 2, 2002.

20. See Hunya at fn.148.

21. In drafting and explaining certain anti-abuse rules, administrations may see merit in not fully articulating the scope of their application in order to avoid providing taxpayers with a "road-map" of how to effectively operate around those rules (i.e. to operate within the letter but not the spirit of those rules). However, aside from these instances, in general transparency should be sought.

22. A range of tax incentive design issues are also discussed in OECD (2001a).

23. In the absence of a reinvestment allowance (or other tax allowance or credit determined as a percentage of current period investment), corporations may first calculate their tax liability on current profit, and then determine how much after-tax profit to distribute in the form of dividends and how much to invest. With a reinvestment allowance (or other incentive equal to some percentage of current investment), the linkage is circular, with CIT influencing the amount of profit available for reinvestment, and reinvestment influencing the amount of CIT. This circularity makes optimal investment strategies more difficult. At the same time, unless taxpayers use an iterative (computer-grid) search for consistent CIT and reinvestment levels, extra funds made available as a result of a reinvestment allowance may be used to increase dividends (rather than increase investment). This is generally what can be expected where the iterative method is not used (i.e. where reinvestment levels are determined on the basis of after-tax profits determined without taking into account the reinvestment allowance). One way to circumvent this circularity problem, is to base the reinvestment allowance in a given year on the amount of qualifying investment made in the previous year.

24. This assumes that a policy-decision would be taken to allow unclaimed balances to be carried forward to offset future tax liabilities, so as not to penalise start-up firms in a non-taxable position when the tax credit or tax allowance is earned.

25. Even introducing an investment tax credit or tax allowance can create confusion as regards the proper treatment and interactions with other provisions. For example, certain systems require that investment tax credits be netted when determining depreciable capital costs, whereas other country systems do not. Unless the relevant legislation is clear on the treatment, the taxpayer may be unsure over the interpretation to give (e.g. when completing a tax return, or during a (pre-investment) screening exercise when comparing after-tax returns when operating from alternative investment locations).

26. Tanzi and Zee argue convincingly in favour of automatic 'triggering mechanisms", particularly in the developing country context. They note that while discretionary granting of relief authorised under generally-worded legislation could, in principle, help target that relief to intended investment-types, it is better to tighten the drafting of the enabling legislation to more closely define qualifying investments.

27. Administrative discretion in targeting tax relief would tend to more problematic (in abetting corruption) the less transparent are the granting procedures and outcomes. Transparency may be improved with public announcements and accounts of granting procedures and outcomes. Scope for abuse may be limited where the number of cases involved is relatively small, a large number of officials are involved, and procedures and outcomes are transparent.

28. In general, difficulties are encountered when attempting to target any tax incentive to foreign investors (perhaps with the exception of reductions in non-resident withholding tax rates). Incentives earned on investment expenditures (e.g. investment tax credits and allowances), and those earned on profits (e.g. a low CIT rate, reinvestment allowance, tax holiday) can only be targeted at foreign investors if they are restricted to 'new' firms meeting a foreign ownership requirement. In practice, limiting an incentive to a 'new' enterprise is problematic, due to creative methods of taxpayers to recharacterise old capital as new.

29. It may be that investors/creditors are unwilling to invest in certain small firms, on account of imperfect information – for example, a lack of knowledge that disables them from assessing risk-adjusted after-tax rates of return. While such situations arise, particularly in the context of firms where the main capital asset is knowledge, it generally is not possible to target incentive relief to such 'true' cases of market failure, to the exclusion of others. Thus caution is required in targeting incentives to small firms on such grounds.

30. While in general support for such activities may be justified, it is difficult to determine what the correct rate of incentive relief should be. One complicating factor is that spillover levels are difficult to measure and value, making it difficult to determine the appropriate incentive rate. Also unclear is how to properly measure social welfare (i.e. how to specify the appropriate social welfare function), recognising that, for example, positive externalities spillover to foreign residents/countries (raising questions over the extent to which domestic revenues should be used to subsidize foreign utility).

31. For example, local investors may be aware of profitable opportunities in a given region, but foreign investors may lack this information, creating difficulties in attracting FDI. This form of market failure (asymmetric information)

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may call for government intervention. One possibility would be for government to assist in disseminating information on the region, for example through embassies or other contact points worldwide (assuming that government can do this more efficiently than the private sector itself). Another possibility would be to use incentives to attract capital. Some would argue that the previous approach is better targeted.

32. Another possibility to address a tax-induced bias for debt finance (linked to the deductibility of interest payments) is to integrate corporate and personal taxation of (domestic) dividend income through the use of imputation credits (and possibly lower individual taxation of capital gains on shares). This report argues elsewhere, however, that SEE countries may be best advised to rely on final withholding taxation at source of domestic dividend income. Under this approach, double taxation of dividend income and preferences for debt are reduced by lowering the CIT rate (which directly lowers the tax rate on profit, while also lowering the value of interest deductions).

33. Possible problems include difficulties in identifying/forecasting cyclical patterns, uncertain lags in developing, drafting and implementing incentives with uncertain and possibly lagged effects. Where these problems are likely to arise, the use of incentives as counter-cyclical instruments should be avoided.

34. To curb "asset churning", countries might consider a 'first-in-use' rule that would deny tax credit or allowance relief unless the asset is being used for the first time in the country (note that this would allow the relief to apply to second-hand assets purchased from abroad that embody technology that is unavailable in the host country). To curb base erosion, countries may wish to deny investment credits/allowances on purchases of assets from related (offshore) companies, where a motivation exists to overvalue the purchase price to maximise the value of the incentive (note that a similar problem exists where firms overvalue prices on inter-group sales to maximise their depreciation bases: an investment credit/allowance increases the tax savings from non-arm's length pricing, with tax savings and base-stripping incentives tied to the incentive rate – see OECD (1995)). Where investment tax credits/allowances are used, countries should obviously consider targeting them in a manner consistent with current or possibly future obligations under relevant EU-law (e.g. which may provide a "carve-out" for incentives targeted at regional development, R&D, job retraining, environmental protection).

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Annex 1.

ILLUSTRATION OF UNINTENDED TAX AVOIDANCE FACILITATED BY TAX HOLIDAY INCENTIVE

Tax avoidance and evasion opportunities created by tax holidays can be demonstrated with reference to a simple example. Consider a pre-holiday situation (illustrated in table AI-1.) where a parent company (PCo) and its subsidiary (OpCoA) both operate in a given host country with a statutory corporate income tax rate of 50%. The parent company may be assumed to be fully or partially foreign-owned. The parent company holds $1000 in operating assets (e.g. plant and machinery) and $1000 in financial assets (bonds and shares) reflecting its ownership of OpCoA. The subsidiary is capitalised with $200 of debt capital and $800 in equity capital. The market rate of interest is taken to be 10%, and the representative firms are assumed to be price-takers in the sense that their lending and borrowing has no impact on the 'world' rate of interest. Therefore, the parent would earn 5% after-tax on bonds (with a 50% corporate tax rate applied to corporate income), which sets in the example the minimum rate of return required by investors on equity shares of equivalent risk. Of course, investors would be attracted to investment projects that provide a post-tax rate of return greater than 5% and would be expected to channel investment funds to such projects.

In the example shown in table AI-1., the subsidiary's operating income is split between interest income and dividends paid to its parent PCo, in accordance with OpCoA's capital structure and the assumed market and shareholder required rates of return. Distributed profits are taxed in the hands of the subsidiary at 50%, while interest — deductible for tax purposes at the subsidiary level — is taxed in the hands of the parent at 50%. As is normal practice, dividends received by the parent from its domestic subsidiary are received tax free (deductible from the tax base) in order to avoid double taxation of the underlying profit amount. As the table shows, a total of $100 in corporate income tax is collected with a 5% after-tax rate of return on the operations of the parent and its subsidiary.

Table AI-2. considers the introduction of a tax holiday, and illustrates the desired outcome of the tax policy. In particular, PCo is shown to invest an additional $500 in the host country, establishing a new subsidiary OpCoB that undertakes the activities qualifying for tax holiday treatment. Targeting under the tax holiday could be towards activities undertaken in a given geographic area in the host country (e.g. a regional tax incentive) or in a given industry (e.g. manufacturing activities). In the example, investment in OpCoB is shown to occur up to the point (at the capital stock level of $500) where the pre-tax rate of return is five per cent, which equals the required post-tax rate of turn under tax holiday treatment.

Table AI-3. also considers the introduction of the tax holiday, but takes into account two possible but unintended incentives created by the new regime. First, it may be that the parent company, rather than expanding its operations, would attempt to recharacterise existing capital already in production as "new" capital qualifying for the tax holiday. An actual expansion may be viewed by the parent as unprofitable, due for example to financing constraints, limited factor supply, or limited output demand. In any event, even where some additional investment is encouraged, the incentive would remain to recharacterise "old" capital as "new". This incentive is illustrated in AI-3. which shows the parent reducing its own operations by $500, and diverting this capital to OpCoB. This has the effect of reducing host country tax revenues as income generated by this capital, previously subject to tax, is now earned tax free.

Second, an incentive is created to structure loans to the corporate group through OpCoB qualifying for the tax holiday. In the example, rather than loaning $200 to OpCoA directly, the parent's tax bill can be

reduced by having this loan intermediated by OpCoB. This can be structured by recalling the loan to OpCoA, investing an additional $200 in equity in OpCoB, which in turn on-loans the funds to OpCoA. The $20 on interest on this loan, which continues to be a deductible expense to OpCoA, is now received tax free in the hands of OpCoB, and converted and paid out to the parent in the form of a tax-free intercorporate dividend.

Together, these distortions have the effect of lowering host country tax revenues to $65, as compared to the $100 figure in Table AI-2. (showing the desired outcome). Furthermore, the reduction in the amount of tax on income generated by OpCoA creates an incentive to expand the amount of capital employed in the non-targeted sector. The example shows that at the existing capital stock level of $1000, OpCoA generates a post-tax rate of return of 6%. This means that the capital stock employed in OpCoA can be increased, while generating above-normal post-tax rates of return. Expansion in OpCoA's capital stock would be expected to continue up to the point where the post-tax rate of return falls back to five per cent. The ability to earn above-normal rates of return on OpCoA operations means that the parent's shareholders enjoy a windfall gain, on account of the tax holiday, on assets employed outside the non-targeted sector.

In addition to encouraging the routing of interest income through the new intermediary OpCoB, an incentive is created to charge OpCoA a non-arm's length price on the loan. By increasing the interest rate charged on the $200 loan above the arm's length (market) rate of 10 per cent, the corporate group is able to reduce its host country tax bill even further. This is illustrated in Table AI-4., which considers the case where the

Table AI-1. **Initial Direct Financing Structure With No Tax Holiday**

	Parent company (PCo)		**Subsidiary (OpCoA)**	
Corporate income tax rate	**50%**		**50%**	
Balance sheet items	**Assets**	**Liabilities**	**Assets**	**Liabilities**
	Operating:	Equity 2000	Operating:	Debt (PCo) 200
	– plant/machinery 1000		– plant/machinery 1000	Equity (PCo) 800
	Financial:			(debt/capital) : (1/5)
	– loans to OpCoA 200			
	– shares in OpCoA 800			
Pre-tax rates of return	Parent operations	**10%**	Subsidiary operations	**10%**
Corporate income tax (CIT)	Net operating income	100	Net operating income	100
	Interest income (*from OpCoA*)	20	Interest expense (@10%)	20
	Dividend income (*from OpCoA*)	40	Net taxable income	80
	Total income	160		
			Corporate income tax (CIT)	**40**
	Dividend received deduction	40		
	Net taxable income	120	Distributed profit	40
	Corporate income tax	**60**		
	- of which			
	-- CIT on PCo operating income	**50**		
	-- CIT on interest income (OpCoA)	**10**		
Post-tax rates of return	Parent operations	5%		
	Subsidiary (OpCoA) operations	5%		
TOTAL CORPORATE INCOME TAX	**100**			

Note: The parent company's required after-corporate tax rate of return on investments is 5% as determined by $i(1-u)=(.10)(1-.5)$ where the market interest rate on bonds (i) is 10% and the host country corporate income tax rate (u) is 50%. The operating surplus of the subsidiary (OpCoA) is taxed in full at the corporate level at rate u (with interest returns taxed in the hands of the parent, and subsidiary profit taxed at the subsidiary level). The required pre-tax rate of return on subsidiary operations (Fk) that yields the 5% required after-corporate tax rate of return is Fk=10% as determined by $i\beta(1-u)+(Fk-i\beta)(1-u)=i(1-u)$ where β denotes the debt/capital ratio (0.2).
The post-tax rate of return on PCo's operations equals (100-50)/1000, while that for OpCoA equals (100-40-10)/1000.

Table AI-2. **Expanded Capital Stock Under Tax Holiday (Illustration of Policy Goal)**

	Parent company (PCo)		**New Subsidiary (OpCoB)**		**Subsidiary (OpCoA)**	
Corporate income tax rate	**50%**		***— qualifying for tax holiday —*** **0%**		**50%**	
Balance sheet items	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
	Operating:	Equity **2500**	Operating:	Equity (PCo) **500**	Operating:	Debt (PCo) 200
	– plant/mach. 1000		– plant/mach. **500**		– plant/mach. 1000	– shares in OpCoA 800
	Financial:					(debt/capital) : (1/5)
	– loans to OpCoA 200					
	– Equity (PCo) 800					
	– shares in OpCoB **500**					
Pre-tax rates of return	Parent operations	**10%**	Subsidiary operations	**5%**	Subsidiary operations	**10%**
Corporate income tax (CIT)	Net operating income	100	Net operating income	25	Net operating income	100
	Interest income (*from OpCoA*)	20	Net taxable income under tax holiday	0	Interest expense (@10%)	20
	Dividend income (*from OpCoA*)	40			Net taxable income	80
	Dividend income (*from OpCoB*)	25	Corporate income tax (***tax holiday***)	**0**		
	Total net income	185			Corporate income tax	**40**
			Distributed profit	25		
	Dividend received deduction	65			Distributed profit	40
	Net Taxable income	120				
	Corporate income tax	**60**				
	- of which					
	— CIT on PCo operating income	**50**				
	— CIT on interest income (OpCoA)	**10**				
Post-tax rates of return	Parent operations	**5%**				
	Subsidiary operations – OpCoA	**5%**				
	Subsidiary operations – OpCoB	**5%**				
TOTAL CORPORATE INCOME TAX	**100**					

Note: The example shows the parent company raising an additional $500 in equity capital to invest in a new subsidiary (OpCoB) qualifying for the tax holiday. The pre- and post-tax rate of return on OpCoB's operation equals 25/500.

Table AI-3. **Intermediated Financing Under Tax Holiday (Unintended Policy Outcome)**

	Parent company (PCo)		Subsidiary (OpCoB)		Subsidiary (OpCoA)	
Corporate income tax rate	50%		*— qualifying for tax holiday —* 0%		50%	
Balance sheet items	**Assets** Operating: – plant/mach. **500** Financial: – shares in OpCoA 800 – shares in OpCoB **700**	**Liabilities** Equity 2000	**Assets** Operating: – plant/mach. **500** Financial: – loans to OpCoA **200**	**Liabilities** Equity (PCo) **700**	**Assets** Operating: – plant/mach. 1000	**Liabilities** Debt (OpCoB) 200 Equity (PCo) 800 (debt/capital) : (1/5)
Pre-tax rates of return	Parent operations	**10%**	Subsidiary operations	**5%**	Subsidiary operations	**10%**
	Subsidiary operations	**10%**				
Corporate income tax (CIT)	Net operating income	50	Net operating income	25	Net operating income	100
	Interest income	**0**	Interest income (*from OpCoA*)	**20**	Interest expense (@10%)	20
	Dividend income (*from OpCoA*)	40	Net taxable income under tax holiday	0	Net taxable income	80
	Dividend income (*from OpCoB*)	45				
	Total net income	135	Corporate income tax (***tax holiday***)	**0**		
					Corporate income tax	**40**
	Dividend received deduction	85	Distributed profit	45		
	Net taxable income	50			Distributed profit	40
	Corporate income tax	**25**				
	- of which					
	— CIT on PCo operating income	**25**				
	— CIT on interest income (OpCoA)	**0**				
Post-tax rates of return	Parent operations	**5%**				
	Subsidiary operations – OpCoA	**6%**				
	Subsidiary operations – OpCoB	**5%**				
TOTAL CORPORATE INCOME TAX	**65**					

Note: The example shows the parent company diverting $500 of its productive capital to OpCoB to qualify for the tax holiday for 'new' investment.
The parent's loan to OpCoA (which does not qualify for the tax holiday) is structured through OpCoB to minimise the tax on earnings of OpCoA (enabling the conversion of taxable interest to exempt dividend income in the hands of the parent).
The post-tax rate of return on PCo's operations is equal to (50-25)/500, while that for OpCoA is (100-40)/1000, and for OpCoB is 50/500.
In the example, the tax holiday generates economic rents (above-normal rates of return) on the (unchanged)physical capital stock ($1000) in OpCoA at $1000. This non-arbitrage result creates incentives to expand the non-targeted capital stock in OpCoA.

Table AI-4. **Transfer Pricing Incentives Under Tax Holiday (Unintended Policy Outcome)**

	Parent company (PCo)		Subsidiary (OpCoB)		Subsidiary (OpCoA)	
Corporate income tax rate	50%		*— qualifying for tax holiday —* 0%		50%	
Balance sheet items	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
	Operating:	Equity 2000	Operating:	Equity (PCo) **700**	Operating:	Debt (OpCoB) 200
	– plant/mach. **500**		– plant/mach. **500**		– plant/mach. 1000	Equity (PCo) 800
	Financial:		Financial:			(debt/capital) : (1/5)
	– shares in OpCoA 800		– loans to OpCoA **200**			
	– shares in OpCoB **700**					
Pre-tax rates of return	Parent operations	**10%**	Subsidiary operations	**5%**	Subsidiary operations	**10%**
	Subsidiary operations	**10%**				
Corporate income tax (CIT)	Net operating income	50	Net operating income	25	Net operating income	100
	Interest income	0	Interest income (*from* OpCoA)	**40**	Interest expense **(@20%)**	**40**
	Dividend income (*from* OpCoA)	**30**	Net taxable income under tax holiday	0	Net taxable income	60
	Dividend income (*from* OpCoB)	**65**				
	Total net income	145	Corporate income tax (*tax holiday*)	0		
					Corporate income tax	**30**
	Dividend received deduction	85	Distributed profit	**65**		
	Net taxable income	50			Distributed profit	**30**
	Corporate income tax	**25**				
	- of which					
	— CIT on PCo operating income	25				
	— CIT on interest income (OpCoA)	0				
Post-tax rates of return	Parent operations	**5%**				
	Subsidiary operations – OpCoA	**7%**				
	Subsidiary operations – OpCoB	**5%**				
TOTAL CORPORATE INCOME TAX	**55**					

Note: The investment structure is the same as that shown in TableAI.3. The ability to convert otherwise taxable interest income from OpCoA to exempt dividend income received from OpCoB creates a 'transfer pricing' incentive to increase the interest rate charged on the loan to OpCoA to an artificially high rate (i.e., a non- arm's length rate), in the example shown to be 20 per cent (rather than 10). The post-tax rate of return on OpCoA's operations increases from 6% (in Table 3) to 7%`, given by (100-30)/1000. This further increases the incentive to expand the capital stock in the non-targeted sector (OpCoA).

interest rate is increased to 20 per cent. Because the interest charge is deductible, this reduces the amount of corporate income tax paid by OpCoA from $40 to $30. As in the previous case, the interest is paid to OpCoB where it is received tax free, which may be then paid to the parent as a tax-free intercorporate dividend. The result is a further reduction in host country tax revenues ($55), an increased rate of return on OpCoA operations, and thus a further incentive to expand the capital stock in the non-targeted sector.

The investment distortions towards non-targeted sectors identified in the examples are noteworthy. In particular, in addition to unintended revenue leakage, the introduction of a tax holiday can create unintended efficiency losses. In general, an efficient allocation of capital requires an equivalence of pre-tax rates of return across assets. This follows simply from the fact that, where pre-tax rates of return differ, aggregated gross returns can be increased by shifting capital away from the least productive towards the most productive uses. Therefore, given that investment behaviour tends to equate after-tax rates of return – placing additional (less) capital towards assets providing higher (lower) after-tax rates of return, tending to decrease (increase) the corresponding pre-tax rates of return – efficiency generally calls for the application of uniform tax rates across assets. One exception to this rule is where uniform taxation leads to an inefficiently low capital stock, for example on account of an inability of investors to fully reap investment returns (e.g. R&D), or due to imperfect information or imperfect capital markets — or more generally, in instances of market failure calling for the introduction of special tax incentives. It follows that efficiencies are lost where income that should be subject to uniform taxation is able to escape the tax net, as in the case of interest income paid by OpCoA in table AI-3.

Annex 2.

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PART II.

COUNTRY STUDIES

Part II consists of eight individual country chapters, each outlining relevant law and practice in eight countries of South East Europe (SEE). The chapters for countries that are participating in the project, and that responded to a questionnaire, are more detailed than for the others. Each chapter examines the foreign investment environment, the tax systems (with a focus on corporate income tax systems), and the investment incentive regimes of the particular country. The analysis is based on information provided by the Ministries of Finance in the different countries, as a snapshot of the situation in 2001. Information on major policy changes in 2002 were provided by the relevant Investment Promotion Agencies and inserted as a postscript.

The country chapters are as follows:

7. Albania *

8. Bosnia and Herzegovina

9. Bulgaria *

10. Croatia

11. Former Yugoslav Republic of Macedonia *

12. Moldova

13. Romania *

14. Serbia and Montenegro *

* Countries participating in the study that responded to questionnaires.

Chapter 7.

ALBANIA

A. Foreign Investment

1. *The Environment for FDI*

Economic reform in Albania began in 1990. In July 1990, two decrees were adopted allowing foreign investment and permitting the creation of joint ventures between foreign firms and Albanian enterprises. In 1991, a Foreign Investment Agency was established. Since 1998, the task of promoting investment in Albania has been undertaken by the Albanian Development Economic Agency. There are proposals to establish a one-stop agency to assist potential foreign investors.

The Albanian Government attaches a high priority to attracting foreign investment, and the formal legal and regulatory obstacles to FDI are few. Nevertheless, foreign investment in Albania has been disappointingly low and although the level of FDI inflows has increased substantially over the past years, it has not increased at the same pace as in many other transition economies. The principal obstacles to FDI seem to have been the poor condition of the physical infrastructure and political instability. The collapse of the highly publicised pyramid schemes in 1997 led to widespread rioting, in which damage to the property of foreign investors was estimated to amount to $50 million. Subsequently, the crises in neighbouring Kosovo and Macedonia added to the perception of instability and risk. The generally acknowledged existence of widespread corruption, organised crime, and general lawlessness has also acted as a major deterrent to investment, although conditions seem to be improving as a result of the firm actions against corruption and crime being taken by the present government.

Summary statistics (2001)

Population: 3.4 million
GDP: $4.1 billion; GDP per capita: $1,210
Inward FDI flows: 2000: $143 mill.; 2001: $200 mill.; 1993–2001 (total): $758 mill.

2. *The Regulation of Foreign Investment*

Foreign investment is regulated by the Foreign Investment Law (No. 7764) of 2 November 1993. A number of other laws and regulations apply to specific sectors (e.g. oil, tourism).

a) Restrictions on FDI

Foreign investment may be made in any sector of the Albanian economy, provided it is not detrimental to national security, defence, public morality or the environment. Investments in sectors of the economy that are considered to be of national importance require the consent of the Council of Ministers (tourism and the oil industry fall within this category). There are no local equity requirements and 100 per cent foreign-owned enterprises are permitted. Nevertheless, the preference for investors to date has been to operate through joint ventures with local partners: of 2,422 companies with foreign capital operating in Albania (in mid-2001), 1532 were joint ventures and 890 were wholly foreign-owned.

b) Approval and Licensing

There is no general requirement that foreign investments be approved, although licenses are required in some sectors (e.g. banking, construction, natural resources). There have been complaints that cumbersome bureaucracy and sometimes corruption make obtaining a license a lengthy and/or costly process. All legal entities operating in Albania must be registered in the Company Register.

c) Forms of Doing Business

The Law on Companies (No.7638), of 19 November 1992, which is based on the German model, prescribes the forms in which business may be carried on in Albania. These are: general partnership; limited partnership; limited liability company (with a minimum capital of ALL 100,000); and joint-stock company either with a public offer (with a minimum capital of ALL 2 million) or limited by shares (with a minimum capital of ALL 5 million). Apparently, the partnership form is almost unknown in Albania. The law permits the establishment of a limited liability company with a sole shareholder. It seems that a foreign investor may also carry on business as an unincorporated sole proprietor.

d) Property Rights

The 1993 Foreign Investment Law provided a number of guarantees and protections for investors. Those guarantees have been reaffirmed and reinforced in the new Constitution, adopted in 1998. Private property is protected under the law, and limitations on the freedom of economic activity may be established only by law and for important public reasons. With the exception of land ownership, foreign investors may not be treated less favourably than domestic businesses.

According to the Law "On the Acquisition of Land"(No. 7980, 27.07.1995) foreign investors are entitled to lease land in state-owned areas. The law on land ownership has since gone through a number of changes. While initially, foreign individuals and entities could only lease land for up to 49 years, that period was increased to 99 years in 1992, and in 1995 the law was further liberalised to permit foreigners to own land for construction, provided they invested at least three times the value of the land. Agricultural land may still not be sold to foreigners. There are no restrictions on the acquisition or leasing of privately owned land.

Foreign investments are protected against expropriation or nationalisation to the same extent as domestically owned property. Expropriation is permitted only in the national interest (typically for infrastructure projects such as roads and airports) and prompt and adequate compensation must be paid.

In addition to the protection provided in the Constitution and in the Foreign Investment Law, Albania has entered into bilateral investment protection treaties with: Austria, Bulgaria, China, Croatia, the Czech Republic, Denmark, Egypt, Finland, France, Germany, Greece, Hungary, Israel, Italy, FYR Macedonia, Malaysia, Netherlands, Poland, Romania, the Russian Federation, Slovenia, Sweden, Switzerland, Tunisia, Turkey, the United Kingdom and the United States. Albania is a member of MIGA, and the Albanian Guarantee Agency, established with the assistance of the World Bank, provides broad political risk insurance for foreign and local investors.

Although the formal framework for protecting foreign investments appears to be satisfactory, enforcement of property rights is generally left to the owner and is not always satisfactory. Corruption remains a problem, especially with the growth of organised crime, and there are reports of judges being subjected to bribery attempts and threats. In particular, intellectual property rights, although protected by legislation, are generally not enforced and violations of copyright and trademarks are widespread.

e) Foreign Exchange

The Albanian *lek* has been relatively stable in recent years and is freely convertible. Transfers abroad of funds and other financial assets are not restricted and, once all relevant taxes and debts have been paid, a foreign investor may freely repatriate profits and the proceeds of the sale or liquidation of the investment

(including compensation for expropriation). However, there have apparently been instances where transfers of funds have been impeded through the application of the recent money-laundering regulations.

f) Import and Export

The Albanian international trade regime has been almost entirely liberalised. There are no important restrictions on imports and almost none on exports. Exceptions exist for goods which maybe hazardous for the country like radioactive and military materials.

g) Dispute Resolution

Disputes relating to foreign investment in Albania may be submitted to a dispute resolution procedure of choice. Disputes between a foreign investor and either a private Albanian party or the Albanian Government may be submitted to arbitration. Under the Foreign Investment Law, Albania has agreed to recognise and enforce any international arbitration award based on a foreign investment dispute. In the case of a dispute involving alleged discrimination, restrictions on the transfer of assets, or expropriation, the dispute may be submitted to the International Centre for the Settlement of Investment Disputes (ICSID).

3. *Privatisation*

Privatisation of agriculture and small and medium-size enterprises (SMEs) has proceeded quite rapidly in Albania. The EBRD *Transition Report* 2001 concluded that the privatisation of small companies had been effectively concluded: by mid-2001, the private sector accounting for 75% of total GDP. A comprehensive scheme for privatisation has been drawn for large-scale enterprises, of which there are relatively few, and some sales have been completed. The sale of the Albania Mobile Communications Company (AMC) in 2000 largely accounted for the steep increase in inward FDI over the previous year. The planned privatisation of the Savings Bank of Albania was announced in July 2001: the bank, the country's largest, holds around 80 per cent of total savings deposits. Foreign strategic partners will be permitted to acquire up to 35 per cent of the offered equity. There are also plans to sell the fixed-line telephone company (Albtelecom) and the state-owned insurance company (INSIG). The process of privatisation is based on the law on Sanction and Protection of Private Property, Free Initiative and Privatisation (No. 7512 of 10 August 1991) which has been complemented by a number of laws regulating the privatisation of strategic sectors.

B. Taxation

The overall level of taxation, and government expenditure, in Albania is relatively low by European standards. In 1999, government expenditures were 32.7% of GDP, and revenues were 21.3%. In 2000, expenditures fell to 31.4% and revenues increased to 22.4% of GDP, thus reducing the substantial budget deficit.

As for the tax mix, central government revenues in 2001 were comprised as follows:

- Income taxes 4.6%
- Social security taxes 15.3%
- Taxes on goods and services 40%
- Taxes on international trade 15%
- Other taxes 3.5%
- Non-tax revenues 15.6%

1. *The Tax System*

a) Formulation of Tax Policy

The Ministry of Finance is responsible for developing tax policy and drafting tax legislation, with other ministries (e.g. Justice) consulted where deemed appropriate. Ministry of Finance drafts are sent to the

government, where they are discussed at ministerial (i.e. Cabinet) level. Once approved by the government, a draft is transmitted to the parliament to be examined by special committees; fiscal policy is scrutinised by the legal and economic committees. The draft, together with the recommendations of the committees, is then put to the general legislative body of Parliament. Parliament has the power to amend a draft law on its own initiative: amendments do not have to be referred back to the Ministry of Finance. A draft becomes law when adopted by the parliament in plenary session.

b) Budget Procedure

The annual budget is prepared by the Ministry of Finance. In preparing the budget, consultations are held with representatives of the business community (e.g. chambers of commerce) and of other groups that may be affected. The budget, and accompanying documents, set out the broad fiscal objectives of the government and the sustainability of the budget over the medium term. Fiscal projections are made by the ministry and are reviewed by the National Statistics Institute, which may make its own suggestions or proposals, which may be sent to the ministry or direct to the government. The ministry does not prepare a tax expenditure budget (the Albanian tax system is relatively neutral and contains very few tax expenditures).

c) Administration and Control

The tax system is administered by the General Taxation Department (which has branches in the 36 districts of Albania) and by the Customs Department, both being divisions of the Ministry of Finance. The National Institute of Social Security manages and administers the social security system, including the collection of contributions. At present, the Institute is under the control of the Ministry of Labour, but there are plans to transfer responsibility to the Ministry of Finance. Property taxes and a few other minor taxes are imposed and collected by local governments and municipalities.

Enforcement of the tax laws remains problematic and taxpayer compliance is relatively poor. Most business is conducted by small enterprises and many transactions are carried out in cash. An EBRD study in 1999 found that registered businesses regard competition from the informal sector as the most important problem they face in doing business, because unregistered firms commonly pay little or no tax. There are statutory audit requirements for larger enterprises (those with annual turnover exceeding 12 m. leks, assets above 6 m. leks, or employing more than ten persons): these must be audited by authorised independent auditors (normally one of the major international accounting firms). Audits are also performed by inspectors from the Ministry of Finance. The audit rate for larger enterprises (i.e. those required to have independent commercial audits) is around 40%. The proportion of smaller businesses that are audited is around 20%, but most of those audits are fairly superficial. Penalties are prescribed for failure to file annual returns and for late payment (at a rate of 0.5% per day of tax unpaid): penalties for concealment of taxable income can be up to 500% of tax concealed.

The tax administration itself is subject to scrutiny through internal audits, conducted by the Supreme Auditing Authority, which is in turn responsible to Parliament. In the past, corruption of and by tax officials has been a problem. According to a 1999 survey conducted by the World Bank, the most important form of corruption, for most firms doing business in Albania, was the payment of bribes to officials to avoid taxes and regulations. In the past two years Albania has taken a number of important measures to combat corruption, including the establishment of an inter-ministerial Anti-Corruption Commission, and a law on internal auditing was adopted in September 2000.

2. *Corporate Income Tax*

The Albanian Profits Tax, introduced by the Law on Profits Tax (No. 7677) of March 3, 1993, takes the classical form when applied to companies, with profits taxed in the hands of the company and dividends paid to individual shareholders being subject to income tax. The law was substantially amended by Law No. 8438 of 28 December 1998, which entered into force in January 1999.

a) Taxpayers

Profits Tax is imposed on the worldwide profits of all resident legal entities and on the Albanian-source profits of non-resident entities that carry on business in Albania through a permanent establishment there. A company is resident in Albania if it has its principal office there. There is no provision for group taxation. Partnerships (resident or non-resident) are in theory treated as legal entities (i.e. they are not transparent for tax purposes); in practice, however, the partnership form is not used in Albania.

Individuals who carry on business are subject to the Profits Tax unless they qualify to be treated as a "small business". A small business is one having an annual turnover which does not exceed 8 m. leks (increased from 5 m. as from 2001): this turnover requirement is the same as the threshold for registration for VAT.

b) Tax Rate

Profits Tax is imposed at a single flat rate of 25 per cent. The rate was previously 30 per cent, but was reduced as from the beginning of 2001. Until 1999, higher rates applied in some sectors (e.g. tourism, oil production).

c) Tax Base

Taxable income is defined as the difference between gross receipts and related expenses. The starting point in determining taxable income are financial statements, drawn up in accordance with the Law on Accounting (No. 7661) of 19 January 1993. The Law on Accounting is based on western European models. For tax purposes, balance sheet profit must be modified in a number of ways, in particular by disallowing certain deductions. Inventory may be valued using the weighted average price method, FIFO, or other approved method, provided the company consistently uses the same method.

d) Inclusions in Income

Taxable income includes interest, management fees, rent, royalties and net capital gains. Capital gains from the disposal of the company's fixed assets are treated as part of its normal business income. Capital losses are treated in the same way as other losses. The treatment of dividends is described below.

e) Deductions

Deductible expenses are those incurred in earning, securing and maintaining profits, other than those items that are specifically disallowed. Deductible expenses include employee remuneration, directors' fees, mandatory social security and health insurance charges. Interest may be deducted to the extent that it is not disallowed under the thin-capitalisation rules (see below) and the rate of interest does not exceed that approved by the Central Bank of Albania. Entertainment expenses are limited to 1% of profits.

Deductions that are disallowed include: the cost of purchase and improving land sites; expenses that may be depreciated; increases of capital; the value of compensation in kind; the cost of fringe benefits provided to employees; voluntary pension payments; dividends to shareholders and distribution of profits to partners; funds transferred to reserves except as allowed for banks and insurance companies; expenses of representation; expenses of a personal consumption nature; taxes, fines and penalties; any other expense, the amount of which is not verified or supported by documentation.

f) Depreciation

The straight-line method of depreciation is used for buildings and structures at 5% and for intangible assets at 10%. Other assets may be depreciated on a declining balance (pooled) basis: computers, software and information systems are depreciated at a rate of 25%, and all other assets at 20%. Depreciation is mandatory,

and recapture provisions apply. No adjustments are made for inflation (Albania currently has a relatively low rate of inflation).

g) Losses

Losses may be carried forward for a maximum of three years (losses may not be carried back). Loss carry-forwards are restricted in the case of a change of ownership of the company (no loss carry-forward is permitted if more than 25% of the share capital of the company is sold to another company).

h) Dividends

Dividends received by a company fall into three categories:

- "Direct dividends" received from a related Albanian company, in which the recipient company holds at least 25% of the share capital or voting rights, are not included in income provided the paying company is subject to profit tax (under the "participation exemption").
- Dividends received from unrelated Albanian companies are included in the recipient company's income, but a credit is allowed for the tax withheld by the payer.
- Dividends received from non-resident companies are included in the recipient company's income, with a foreign tax credit allowed for the tax withheld by the foreign payer (see "International Aspects" below).

An Albanian resident company paying a dividend must withhold tax, except where the participation exemption applies. Tax is withheld at the rate of 15% on dividends paid to a resident company (holding less than 25% of the payer company's shares or voting rights), and at 10% on payments to resident individuals. In the case of payment to a non-resident, a lower rate may be prescribed by tax treaty (see "International Aspects" below).

i) Anti-Avoidance Provisions

There is no general anti-avoidance provision in Albanian tax law, nor is there controlled foreign company (CFC) legislation. Thin capitalisation rules restrict the deduction of interest where the debt/equity ratio exceeds 4:1, and the loan is made by a shareholder or by an "associated person". The same definition of associated person is employed in the transfer pricing provisions. These permit an adjustment to be made, by a commission of the General Tax Department, if conditions set in a transaction between associated persons differ from those that would have been made in an arm's length transaction. In making adjustments, the commission is required to refer to the OECD Transfer Pricing Guidelines. It is only very recently that the Albanian authorities have begun to apply its transfer pricing rules.

3. International Aspects

a) Foreign Tax Credit

Albanian tax law allows a unilateral credit for foreign tax paid on income included in the taxable income of Albanian residents. The credit is calculated on a per-country basis. In the case of dividends from foreign companies the credit extends only to withholding tax; where a tax treaty applies, however, there may also be a credit for underlying corporate income tax.

b) Non-resident withholding

A 15% withholding tax is levied on the following payments to non-residents: dividends, interest and royalties; fees for technical service and management fees; and payments for construction, installation, assembly or related supervisory work. The withholding tax rate may be reduced by treaty. The relevant treaty withholding rates are:

- Direct dividends:
  5% in the cases of Bulgaria, Czech Republic, Greece, Hungary, Malaysia, Norway, Poland, Sweden, Switzerland and Turkey;

10% in the cases of Croatia, Italy, FYR Macedonia, Romania and Russia.

- Portfolio dividends:
  10% in the cases of Croatia, Hungary, Italy, FYR Macedonia, Poland and Russia;
  15% in all other treaty cases.

- Interest:
  0% in the case of Hungary; 5% in the cases of Czech Republic, Greece, Italy, Malta, Sweden and Switzerland; 10% in all other treaty cases.

- Royalties:
  5% in the cases of Greece, Hungary, Italy, Malta, Poland, Sweden and Switzerland;
  10% in other treaty cases, except Romania, where a 15% rate applies.

Negotiations are under way for tax treaties with Egypt, France, Germany, Kuwait, Slovenia, the United Kingdom and the United States.

4. *Individual Income Tax*

The Personal Income Tax Law (No. 7786 of 27 January 1994, as amended) adopts a schedular system. Employment income including directors' remuneration is taxed at progressive rates, with the first 10,000 lek per month being exempt from tax. The top rate of 25% is payable on monthly income in excess of 80,000 lek.

Dividends, interest and royalties received from Albanian companies are subject to a flat final 10% withholding tax. Rents are assessed to a flat 10% tax. Gambling and lottery winnings are taxed at 20%. There is no general tax on capital gains, but the proceeds of sale of land are taxed at progressive rates from 0.5% to 3%.

Business income is not (in most cases) taxed under the Personal Income Tax, but is usually subject to a separate tax imposed by the Law on Small Business Tax (Law No. 8313), which took effect in 1998 (replacing an earlier 1993 law). Small businesses are divided into two categories – those with an annual turnover not exceeding 2 million leks, and those with a turnover exceeding 2 million but not exceeding 8 million leks.

Businesses in the lower category pay a flat "table tax", so called because the amount is ascertained from a published table. The amount of tax is prescribed according to the type of business and its locality. Businesses in the higher category pay the table tax and, in addition, pay a turnover tax, at 4% on turnover in excess of 2 million leks. This turnover tax acts as a substitute for VAT. If annual turnover exceeds 8 million leks, the business is subject to the Business Profits Tax and must also register for VAT.

Non-resident individuals are taxed only on Albanian-source income. There is no special tax regime for expatriates.

5. *Social Security Contributions*

Social security and health insurance contributions are payable by both employer and employee and are based on gross salary. The employer pays social security contributions at the rate of 32.5% on monthly salary between 6,040 and 18,120 leks: the employee pays at the rate of 10%. Employer and employee each pay health insurance premiums of 1.7% of gross salary. Expatriates may choose between Albanian law and the law of the country of origin.

6. *Consumption Taxes*

a) Value-Added Tax

VAT was introduced in 1995 (Law No. 7928 of 27 April 1995) and came into effect on 1 July 1996. The Albanian VAT is based closely upon the EC system. The standard rate is 20%: a zero rate applies to exported goods and services. There are no reduced rates. The VAT registration rules are the same as those for the Profits Tax. Refunds may be made where the amount in question exceeds 400,000 leks (otherwise it must be carried forward as a credit). Refunds to exporters are required to be made within 30 days of application.

As an investment incentive, machinery and equipment that is imported to be used in production, construction or telecommunications is not subject to VAT at the time of import. VAT is imposed after three years from the date of importation, on the depreciated value.

b) Excise Taxes

There are the usual excise taxes on alcohol, mineral oils and tobacco as well as a few other items, such as coffee, perfumes and soft drinks. Exports are exempted from excise tax.

7. *Import Duties*

Imports are subject to duty according to their classification in the (Brussels) harmonised system. There are four rates: 0%, 2%, 10% and 15%. Albania joined the WTO in September 2000 and in June 2001 signed the framework agreement for the creation of a Balkan free trade zone.

8. *Other Taxes*

Companies are subject to a transfer duty on the sale of land and buildings. Property tax, on buildings, is levied by local authorities.

C. Investment Incentives

Prior to 1999, Albania experimented with a number of investment incentives, including tax holidays and reinvestment allowances. These earlier incentives were repealed due to concerns over their effectiveness, while permitting full four-year tax relief to existing investors who had already qualified under the tax holiday programme. Since initiating its reform process, Albania has placed very little reliance on special tax incentives to promote investment, limiting tax relief to the VAT and customs duty areas.

The following briefly describes the incentives in place in 2001:

1. VAT *and customs duty incentives*

- VAT *and customs duty deferral* – a company, whether foreign or domestically owned, that imports machinery or equipment (or receives an in-kind contribution of share capital) to be used for production, construction or telecommunications purposes, is permitted a *deferral* (not an exemption) on the payment of VAT and customs duty, for a period of three years. At the end of the three-year period, VAT and duty are payable on the depreciated basis of the asset, with VAT applied at the normal rate, and duty applied at a 2% rate.

2. *Zone incentives*

- *Duty-free zones* – legislation was adopted in 1996 for the creation of duty-free zones in Albania to encourage foreign investment and the introduction of new technology. Companies operating in duty-free zones may enjoy tax privileges in the first several years of activity (e.g. exemption from profit

tax). A National Entity of Free Zones was set up in January 1997 (as an institution attached to the Council of Ministers) and a number of studies were carried out, leading to proposals to create zones in the prefectures of Durres and Vlora and in locations on the borders with Greece and Yugoslavia (FR). The Law on Free Zones (No.8636 of 6 July 2000) further regulates the conditions for establishment of free zones and related matters. In a Letter of Intent to the IMF, in December 1998, the Albanian Government stated that it was not proposing to grant tax holidays to companies operating in the zones. To date, no such zone seems to have been established.

3. *General Experience with Investment Incentives*

As noted, prior to 1999, the main incentives in place were tax holidays and reinvestment allowances (a reliance on profit-based and expenditure-based incentives). The provisions were enriched for investment in targeted tourism-development zones:

- *Tax holidays* – under the original Law on Profits Tax, a tax holiday of four years was granted to domestic and foreign investors in the manufacturing sector, provided the investment was for a period of ten years or more. Investors in priority tourism-development zones were given a five-year tax holiday. The holiday provisions were grandfathered (companies already eligible for the concessions were permitted to retain their privileges).

- *Reinvestment allowance* – a reinvestment allowance was provided, claimed against Profits Tax, and earned at the rate of 60% on the portion of investment financed by retained earnings. Investors in priority tourism-development zones were given an additional 40% reinvestment allowance (implying a 100% allowance). This incentive was grandfathered for the transition year.

Officials have explained that their experience has shown that such incentives did not have their intended effect in attracting domestic and especially foreign investments in production activities in Albania. The experience also has shown that when these incentives were removed, this was done without adverse effects on investment flows.

D. Postscript

The Albanian parliament approved the law on the Establishment of a Foreign Investment Promotion Agency. The new agency's function consists of implementing government policy aimed at increasing foreign investments in Albania. This Agency will shortly start operating. The main objectives of this agency are: improving the investment climate in Albania, facilitating the investment process, providing the necessary information on investment procedures and policy advocacy.

The amended Personal Income Tax Law taxes income at progressive rates, with the first 4,000 lek per month being exempt from tax.

Chapter 8.

BOSNIA AND HERZEGOVINA

The State of Bosnia and Herzegovina comprises two "entities" – the Federation of Bosnia and Herzegovina and the Republic of Srpska. (The disputed region of Brcko is presently under international administration.) The State has jurisdiction over international affairs, foreign trade, customs and monetary policy. Most other matters, including taxation, are in the hands of the entities. Foreign investment is regulated at both levels of government. The basic framework is provided by the (State) Law on the Policy of Foreign Direct Investment in Bosnia and Herzegovina, but most of the detailed provisions affecting investment are established at the entity level.

A. Foreign Investment

1. *The Environment for* FDI

Although hostilities in Bosnia and Herzegovina came to an end in 1995 with the Dayton peace agreement, the country has continued to suffer from political instability and neither the Federation of Bosnia and Herzegovina nor the Republic of Srpska has been able to attract much investment, although FDI is expected to increase as the privatisation programme takes effect. The growth of investment in 2000 was principally due to foreign participation in the privatisation of two banks.

With the more recent changes that have occurred in neighbouring Croatia, Serbia and Montenegro, the situation has improved to some extent and both entities are now making efforts to attract FDI. Nevertheless, progress with economic reform has been slow. There have been numerous reports that corruption, in both entities, is seen as a major obstacle to investment and some investors have pulled out, complaining of excessive interference from government, demands from officials for kickbacks, and inability to collect debts. However, in late 1999 an extensive anti-corruption programme was adopted in both entities.

***Summary statistics* (2001)**

Population: 4.1 million (Federation of Bosnia and Herzegovina: 2.6 mill.; Republic of Srpksa: 1.5 mill.)
GDP: $4.8 billion; GDP per capita: $1,163
Inward FDI flows: 2000: $150 mill.; 2001: $130 mill.; 1993–2001 (total): $471 mill.

2. *The Regulation of Foreign Investment*

The Law on the Policy of Foreign Direct Investment (the FDI Law) adopted at the state level in March 1998 provides the basic framework for FDI in both entities, but the detailed provisions affecting investment are mostly established at the entity level. The Law (art.21) requires the State and the entities to issue implementing regulations, and to co-operate to achieve the objectives set out (art.23), the entities being responsible in their respective territories for the implementation of the Law (art.22). The Law (art.6) also provides for the establishment of an institution to promote and facilitate foreign direct investment. This has been done, in the form of the Foreign Investment Promotion Agency (FIPA), whose responsibilities extend to the entire State.

Despite the requirement of the FDI Law to co-operate, the result has been described as "a maze of often contradictory or duplicative laws and regulations at the State, entity, cantonal and municipal levels of government." (FIAS, 2000). However, during the latter part of 2001 both entity governments adopted new laws on foreign investment, which should have improved the situation.

a) Restrictions on FDI

According to the FDI Law, foreign investors are entitled to invest, and to reinvest profits, in all sectors of the economy, in the same form and under the same conditions as defined for residents (art.3). This basic principle is subject to the one limitation (art.4) that stipulates that the proportion of foreign equity ownership may not exceed 49% in the armaments, telecommunications and media sectors.

Foreign investors may establish wholly-owned subsidiaries, enter into joint ventures with local enterprises, or acquire the shares or property of a local enterprise. Up to the end of 1999, about 40% of foreign investments took the form of joint ventures.

b) Approval and Licensing

The FDI Law requires foreign investors to register their investment with both the State authorities and those of the respective entity, leaving it to the entities to prescribe the registration requirements. The Foreign Investment Law of the Republic of Srpska (RSFIL), for example, specifies in detail the contents of the investment contract. Investments in the restricted sectors require the prior approval of the entity authorities.

c) Forms of Doing Business

It seems to follow from the basic principle of non-discrimination that foreign investors may operate using any of the forms available to local businesses. In accordance with the constitutional separation of powers, each entity has its own company law. The RSFIL, for example, allows foreign investors to invest in a public enterprise, joint-stock company, limited liability company, limited partnership, co-operative, or "any other form of co-operation or joint business activity determined by law" (art.9).

d) Property Rights

According to the FDI Law (art.12), foreign investors have the same property rights in respect to real estate as citizens and legal entities of Bosnia and Herzegovina. However, a problem for foreign investors is that there is a lack of current and accurate records of land ownership, making it difficult to establish good title. Also, there is no clear policy on restitution and compensation for claims on appropriated property, which makes for considerable uncertainty in view of the large-scale movements of populations that occurred during the conflict. The courts also have a reputation for inconsistency in upholding and enforcing sales and leasing contracts.

The FDI Law (art.16) provides that expropriation or nationalisation is permitted only for a public purpose and with adequate and prompt compensation. It further provides a guarantee that rights acquired under that law cannot be terminated or eliminated by any subsequent legislation. If a subsequent law is more favourable, the investor may choose under which regime it is to be governed.

e) Foreign Exchange

One of the major achievements of the reforms instituted since the Dayton agreement has been the virtual elimination of inflation and the introduction (in 1998) of a stable, convertible, currency – the konvertibilna marka (KM). The FDI Law (art.11) guarantees the right of investors to freely convert domestic currency into any other convertible currency, and to repatriate profits, proceeds of sale, property or compensation.

f) Import and Export

A programme of trade liberalisation is gradually being implemented, with customs surcharges set to be eliminated by the end of 2002. A free trade agreement with Croatia came into effect in 2001, and negotiations with the EU are intended to result in full mutual free trade within 10 years.

g) Dispute Resolution

Under the FDI Law, all disputes arising from investments may be resolved before the courts, or may be referred to domestic or international conciliation or arbitration by agreement of the parties.

3. *Privatisation*

Privatisation is regarded as one of the keys to reform and of prime importance in attracting FDI. To date, however, it has proceeded slowly apart from the privatisation of banks and the financial sector. Privatisation only started in 1999, although it is intended to be completed by 2003. In the Federation of Bosnia and Herzegovina, enterprises are sold by auction or tender. In the Republic of Srpska, privatisation of small enterprises has been through a mixture of cash and voucher sales.

B. Taxation

The overall level of government expenditure in Bosnia and Herzegovina is high by international standards, reaching 57% of GDP in 1999. Tax evasion and smuggling have been widespread, resulting in large budget deficits in both entities.

1. *The Tax System*

With the exception of customs duties, taxation is the responsibility of the entities. Although the IMF, in particular, has emphasised the need to harmonise the various entity taxes, little progress has been made except in the field of excise duties. Otherwise, each entity has its own distinct tax system, although the taxes that are levied are mostly the same.

As regards foreign investors, the FDI Law (art.9) provides that taxation shall be in accordance with the tax legislation of the entities, but, in order to encourage investment, the entities "shall ensure that tax legislation … contains attractive features and rates", and that "corporate tax regimes should not discriminate between foreign and domestic investments".

2. *Corporate Income Tax*

Both entities inherited (from (FR) Yugoslavia) the 1992 company profit tax. That tax remains in force in the Federation of Bosnia and Herzegovina, but a new Law on Corporate Income Tax was adopted in the Republic of Srpska in 1998. In both entities CIT is imposed on all legal persons.

a) Tax Rate

In the Federation of Bosnia and Herzegovina, the CIT rate is 30%. The Republic of Srpska has an unusual rate schedule, which is regressive in nature. Profits are taxed as follows:

- Up to 100,000 KM 20%.
- 100,000 to 300,000 KM 15%.
- 300,000 to 500,000 KM 12%.
- Over 500,000 KM 10%.

The ostensible rationale for this system is to provide an incentive to declare profits, although it seems to have proved ineffective in this regard.

b) Tax Base

Taxable income in both entities is determined by accounting profits, adjusted for tax purposes. Deductible expenses are mostly the same in each entity.

c) Losses

Losses may be carried forward for five years. There are no loss carry-back provisions.

3. *International Aspects*

A number of tax treaties concluded with the former Yugoslavia remain applicable to Bosnia and Herzegovina. These include treaties with: Belgium, Cyprus, the Czech Republic, Denmark, Finland, Germany, Hungary, Luxembourg, the Netherlands, the Slovak Republic and Sweden.

4. *Individual Income Tax*

In the Republic of Srpska, personal income tax is imposed at the entity level. Individuals are taxed on their total income from all sources (including business). Tax is imposed on (annual) taxable income according to the following schedule:

- Less than 10,000 KM 0%.
- 10,000 – 15,000 KM 25%.
- 15,000 – 25,000 KM 20%.
- Over 25,000 KM 15%.

The procedures for withholding tax on wages are described as "extremely bureaucratic and onerous, resulting in significant processing and compliance costs for the employers".

In the Federation of Bosnia and Herzegovina, personal income tax is imposed at the cantonal level, the rates being specified by each canton. In addition, there is a surtax (payable to the entity) on incomes in excess of three times the annual average salary in the respective canton.

5. *Social Security Contributions*

Social security contributions are paid by the employer and amount to approximately 50% of gross salary.

6. *Consumption Taxes*

Neither the Federation of Bosnia and Herzegovina nor the Republic of Srpska has as yet introduced a value-added tax. A general sales tax applies to both goods and to some services. In the Federation of Bosnia and Herzegovina the standard rate is 20%; while in the Republic of Srpska, it is 18%. Lower rates apply in some cases.

The two entities agreed in 1999 to harmonise the system and rates of excise tax, in an attempt to reduce the volume of smuggling. Discussions to that end are currently taking place. Excisable goods are tobacco, alcoholic beverages, fuel products, coffee and some luxury products.

7. *Import Duties*

According to the Constitution, customs policy is the responsibility of the State, and the whole of Bosnia and Herzegovina is considered to be a single customs territory. However, the collection of customs duty is administered separately in each entity.

C. Investment Incentives

Since taxes, with the exception of customs duties, are established at entity level, there are differences between the incentives offered in each. The FDI Law attempts to prevent tax competition between the entities, providing that "the entities recognise that competition in granting incentives is undesirable and that they are committed to avoiding such competition." (art.9). The following incentives are available in 2001:

1. *Expenditure-based incentives*

- *Investment allowance* – in the Federation of Bosnia and Herzegovina, an investment allowance (deduction from taxable profits) is provided, earned at a 100% rate on qualifying investment in fixed assets. The allowance does not affect the depreciation basis of the assets. In the Republic of Srpska, the investment allowance is capped at 15% of taxable profit.

2. *Profit-based incentives*

- *Tax holiday (foreign participation)* – companies satisfying a foreign participation threshold (minimum of 20% of total capital) are entitled to a five-year profit exemption proportionate to the percentage of foreign ownership. Companies that are 100% foreign-owned enjoy a complete tax holiday (full profit exemption) for five years (companies 70% owned by non-residents have 70% of profits exempt from corporate tax). In the Republic of Srpksa, the tax holiday period begins in the year of commencement of operations, while in the Federation of Bosnia and Herzegovina the commencement date is determined by the tax administration.
- *Tax holiday (new firms)* – newly established companies receive a 100% profit exemption in the first year of operation, a 70-75% profit exemption in the second year, and a 30% profit exemption in the third year.[1]
- *Tax holiday (regional)* – new companies established in a region designated to be underdeveloped receive a 100% profit exemption in the first three years of operation. This tax incentive applies only in the Republic of Srpksa.

3. *Customs duty incentives*

- *Customs duty exemption* – an exemption from customs duties is granted in respect of new equipment (other than motor vehicles or gambling machines) imported by foreign investors.

4. *Zone incentives*

- *Free-trade zones* – the regulations governing the establishment and operations of free zones appear to be based on the Yugoslav law of 1994, although each of the entities has its own law on the subject. A number of free zones have been established in the Federation of Bosnia and Herzegovina, in Bihac, Lukavac, Mostar, Sarajevo, Travnik and Visoko. In the Republic of Srpska, a free zone has been established in Banya Luka.

The tax incentives provided to companies operating in the free-trade zones are as follows:

– *tax exemption*: in the Federation of Bosnia and Herzegovina, zone enterprises are exempt from *all* taxes (apart from tax on salaries).
– *tax holiday* – in the Republic of Srpska, companies are provided with a 5-year tax holiday from corporation income tax.
– *customs duty exemption* – no customs duties are charged on goods entering the zones.

5. *General Experience with Investment Incentives*

The main reaction of investors to the incentives regime is that the provisions are lacking in clarity, and were not interpreted or applied in a consistent manner.

D. Postscript

In July 2001, the Bosnian Serb Republic (Republic of Srpska) Assembly adopted a package of 11 tax laws that are intended to bring the Republic of Srpska closer to European economies. The new laws included profits tax, personal income tax, property tax and tax administration. In October 2002, the Federation government announced a package of economic and judicial reforms, including the introduction of a new VAT law.

NOTE

1. The profit exemption in the second year is 75% for investments in the Federation of Bosnia and Herzegovina, and 70% in the case of Republic of Srpska.

Chapter 9.

BULGARIA

A. Foreign Investment

1. *The Environment for* FDI

Economic reform in Bulgaria began in 1991 with the liberalisation of almost all prices and the ending of the state monopoly on foreign trade. A framework for foreign investment was provided in 1992 by the Law on Economic Activity and on Protection of Foreign Investments. The law was amended in 1996, and then replaced by a new law in 1997. That Law significantly improved the investment environment and established the Bulgarian Foreign Investment Agency as the government's body for co-ordinating foreign investment.

During the early years of transition, FDI was low due in part to the foreign exchange crisis that developed in March 1994, when the *lev* (BGL) lost more than half its value against the dollar and the annual inflation rate reached almost 100%. A second crisis occurred at the end of 1996, the government resigned, inflation soared to over 200% and the BGL depreciated by more than 500% against the US$. That crisis subsided quite quickly with the appointment of a new government, and FDI inflows in 1997 were five times greater than in the previous year. Since then, despite the disturbances in neighbouring countries, FDI has continued to grow and in 2000 exceeded $1 billion. Inflation fell to 5.4% in 1998 and to 4.8% in 2001.

Bulgaria is generally considered to have a liberal foreign investment environment, with few legal and regulatory obstacles to FDI. The problems most often cited by foreign investors are poor infrastructure, excessive bureaucracy, frequent changes in legislation (often with little advance notice), an inadequate banking system, and a large "grey" economy. In recent years the Bulgarian Government has taken firm action against corruption, including the introduction of a law against money laundering, but many investors believe that corruption, and political influence over business decisions, continue to be a problem.

***Summary statistics* (2001)**

Population: 8.1 million
GDP: $12.7 billion; GDP per capita: $1,570
Inward FDI flows: 2000: $1002 mill.; 2001: $689 mill.; 1993–2001 (total): $3,896 mill.

2. *The Regulation of Foreign Investment*

Foreign investment is now regulated by the Foreign Investment Law of October 24, 1997. Banking and insurance activities are regulated by separate laws. A number of the provisions of the Constitution are also relevant.

a) Restrictions on FDI

FDI is permitted in most sectors of the economy. The Bulgarian Constitution of 1991 reserved a number of activities to the state, while providing that "concessions" may be granted to privately owned undertakings to carry on business in those sectors (i.e. licenses are required, with the granting of concessions regulated by the Concessions Law of 1995). The principle sectors are: mineral resources, development of the waterfront and continental shelf, postal services, roads, waterways and airports, electric and nuclear power plants, passenger transportation, arms and explosives. The law was amended in 1997 to allow B-O-T arrangements. Since 1998 further legislation has permitted concessions in telecommunications, energy, mining, etc. Amendments were again made in 2000, resulting in further liberalisation of investment conditions.

There are no local equity requirements for investors and 100 per cent foreign-owned enterprises are permitted.

b) Approval and Licensing

Apart from the legislation governing concessions, there is no general requirement that foreign investments be approved.

c) Forms of Doing Business

Investors in Bulgaria may carry on business in the form of a private limited company (limited liability company), a public limited (joint stock) company, a partnership (general or limited), a joint venture or as a sole proprietorship. A foreign legal entity may also establish a branch or a representative office in Bulgaria. By far the most common business form is the private limited company, which may be formed by one or more persons. The minimum foundation capital for a private limited company is BGL (new) 5000. There are higher requirements for banks, insurance and investment companies.

d) Property Rights

The Constitution, as well as the Foreign Investments Law, provides for national treatment for foreign investors, except with respect to land ownership. Under the Constitution, foreign nationals and foreign legal entities are not permitted to own land directly, although they may lease buildings. However, the restriction does not apply to Bulgarian legal entities with foreign participation. Thus, a foreign investor can establish a wholly-owned subsidiary in Bulgaria which is allowed to own land. There are some restrictions on ownership of land, even indirectly through a Bulgarian legal entity, in some border areas.

Foreign investments are protected against expropriation or nationalisation to the same extent as domestically owned property. Expropriation is permitted only in the national interest and where the needs of the state cannot otherwise be met, and prompt and adequate compensation must be paid. In the case of expropriation of land, the investor can require compensation in the form of an alternative piece of land in the same location or a different location, or in cash.

Prior to 1998, Bulgaria had been one of the world's leading sources of pirated compact disks and CD-ROMs and had been placed on the U.S. "priority watch list" as a result. However, intellectual property rights have recently been strengthened and the Bulgarian legislation is now considered to be among the most modern in Europe (leading to Bulgaria's removal from the U.S. watch list). Nevertheless, it seems that infringement of trademarks remains a problem for some investors.

Bulgaria has entered into bilateral investment protection treaties with: Albania, Argentina, Armenia, Austria, Belarus, Belgium-Luxembourg, China, Croatia, Cuba, Cyprus, Czech Republic, Denmark, Egypt, Finland, France, Georgia, Germany, Greece, Hungary, India, Israel, Italy, Kazakhstan, Kuwait, Lebanon, FYR Macedonia, Malta, Moldova, Morocco, the Netherlands, Poland, Portugal, Romania, the Slovak Republic, Slovenia,

Spain, Syria, Sweden, Switzerland, Turkey, Ukraine, United Kingdom, United States, Uzbekistan, Vietnam and FR Yugoslavia. Under Bulgarian law, treaty rights prevail over conflicting national law.

The Foreign Investments Law provides an important additional protection to investors in the form of a guarantee against adverse changes in the law.

e) Foreign Exchange

The Bulgarian *lev* has been relatively stable since the 1997 reforms and is freely convertible. A foreign investor may freely repatriate profits and the proceeds of the sale or liquidation of an investment, once all relevant taxes and debts have been paid. The Foreign Currency Law of 1999 requires transfers exceeding BGL 20,000 be approved by the Bulgarian National Bank. Foreigners are permitted to export without prior approval as much currency over the foreign currency equivalent of BGN 20,000 as they have imported into Bulgaria.

f) Import and Export

Bulgaria is a member of the WTO and CEFTA. It has an Association Agreement with the EU and free trade agreements with EFTA, Croatia, Estonia, Israel, Lithuania, FYR Macedonia and Turkey. (Since 1 January 2002, trade in industrial goods between Bulgaria and the EU, EFTA, CEFTA and Turkey is duty free.)

Its trade regime generally meets WTO requirements. A limited number of products are subject to administrative control.

g) Dispute Resolution

Disputes relating to a foreign investment may be decided through the normal court system or, by agreement, submitted to arbitration. Parties to commercial disputes may submit their dispute to foreign arbitration or to international domestic arbitration in Bulgaria. Pursuant to the Bulgarian law on international commercial arbitration, parties who have their domicile or seat in Bulgaria may use only the international domestic arbitration court in Bulgaria. The Court of Arbitration at the Bulgarian Chamber of Commerce is the main arbitration agent for settling disputes. Bulgaria accepts binding international arbitration in disputes with foreign investors and is a signatory of the ICSID convention. Bulgaria is also a signatory to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, and to the European Convention on International Commercial Arbitration.

3. *Privatisation*

Bulgaria's privatisation process is governed by the Law on Transformation and Privatisation of State and Municipal-Owned Enterprises, of 1992. That law permits foreign entities to participate in the process. Since the 1997 reforms, substantial progress has been made. The EBRD *Transition Report* 2001 concluded that the privatisation of small companies was almost complete and that almost a half of large-scale enterprises had been privatised by the end of 2000, with the private sector accounting for 70% of total GDP. Receipts from privatisation account for one-third of total FDI inflows, and only exceeded non-privatisation flows in 1994 and in 1997. There have been complaints by potential foreign investors that the privatisation process is unduly protracted and there have been accusations of political influence in the sale of state-owned enterprises. Uncertainties over redundancy and environmental policies have caused a number of investors to prefer greenfield investment.

B. Taxation

The overall level of taxation, and of government expenditure, in Bulgaria is moderate by European standards. In 1999, government expenditures were 33.5% of GDP, and revenues where 33.9%, providing an overall budget surplus. Central government revenues for 1999-2001 were made up as follows:

	1999	2000	2001
Profit tax	7.7	6.7	9.6
Personal income tax	10.9	9.9	9.0
Social insurance contributions	24.5	26.6	25.2
Value added tax	19.9	21.3	20.8
Excise duties	7.1	9.4	9.4
Customs duties	2.7	2.0	1.7
Other taxes	4.4	2.8	2.0
None tax revenues	22.7	21.3	22.4

1. *The Tax System*

a) Formulation of Tax Policy

The Tax Policy Directorate of the Ministry of Finance is responsible for formulating tax policy and for drafting amendments and supplements to the tax laws. In the process of drafting new legislation, the opinions of various business and social organisations are taken into consideration. Before a draft law is submitted to the Council of Ministers, it goes for internal co-ordination within the Ministry of Finance and for external co-ordination to other ministries and relevant administrative bodies.

When the Council of Ministers adopts a decision in relation to any tax law, it submits the proposed amendment to the National Assembly, which has the legislative power in Bulgaria to adopt, amend or repeal all laws and to establish taxes and their amounts. A draft tax law is first discussed by the Assembly's budgetary committee. The Assembly adopts the draft law in two readings in the first reading the law is adopted in principle, in the second it is adopted article by article.

b) Budget Procedure

The Tax Policy Directorate is responsible for preparing estimates of the revenue impact of budget changes. An estimate is made of tax expenditures and these are identified in the budget. Fiscal projections are reviewed by the National Statistics Office.

c) Administration and Control

The tax system is administered by the General Tax Directorate, which is a separate legal entity under the control of the Ministry of Finance. The tax administration has 28 territorial directorates and five regional directorates. The Audit Office is responsible for verifying the implementation of the state and municipal budgets and the various social security budgets. The National Assembly exercises parliamentary control over the various ministries and departments. The legality of the acts of administrative bodies is subject to the supervision of the courts, with the Supreme Administrative Court exercising supreme judicial supervision over administration.

The Corporate Income Tax Law does not provide for regular audits of returns, unless the taxable person claims a refund, in which case a tax audit is mandatory. The standard procedure is that the tax inspectors review all tax returns and carry out an audit whenever there are indications that the taxable income may be incorrectly stated. In practice, companies tend to be audited at least once during the period of the statute of limitation.

The current rules for tax audits were introduced by the Tax Procedural Code, which applies from 1 January 2000. A taxpayer is notified regarding a tax audit when it commences. The tax inspectors have wide powers to examine records and to request information.

A study conducted by the FIAS in 1998 found that investors tended to be more concerned about tax administration than about the level of taxation. There was a need for more detailed and comprehensive regulations, interpretative bulletins, and greater transparency generally. Procedures should be simplified and the amount of paper work reduced. The study recommended in particular that a programme should be offered for advance rulings to large investors. Foreign investors have also complained that widespread tax evasion by domestic enterprises places them at a competitive disadvantage. Towards the end of 1997, the government initiated a short-term programme of improvements in tax administration, in particular setting up a large-scale taxpayers unit to closely monitor the 600 or so taxpayers that account for about 80% of tax revenues.

2. *Corporate Income Tax*

The Corporate Income Tax Law was introduced on 5 December 1997 and took effect from January 1, 1998. It was amended in December 1999. The Bulgarian corporate income tax (CIT) is essentially of the "classical" type, with profits being fully taxed at the corporate level and distributions being taxed in the hands of the individual shareholders. Dividends paid to another resident company are tax-free in the hands of the recipient.

a) Taxpayers

The CIT is imposed on the worldwide profits of all resident companies and partnerships and on the Bulgarian-source profits of non-resident entities that carry on business in Bulgaria through a permanent establishment there. A company is treated as resident in Bulgaria if it is registered there. There is no provision for group taxation. Individuals who carry on business as sole proprietors are taxed under the Personal Income Tax Law, but their business income is calculated according to the provisions of the CIT. There is no group taxation.

b) Tax Rate

Both the central government and municipal governments impose CIT. The municipal tax is levied at a rate of 10%, and the central tax at 20%. The municipal tax is treated as a deduction from taxable income, so that the effective central tax rate is 18%, giving a combined (total) rate of 28%. The (central) tax rate has been progressively reduced from 40% in 1995, 30% in 1998, 25% in 2000, and 20% in 2001. (The municipal rate has remained fixed at 10% since 1998.)

Small companies and partnerships (with annual taxable profit not exceeding 50,000 BGL) are taxed at a lower rate in 2001 their rate was 15% compared with the standard rate of 20%, giving a total combined rate of 23.5%.

c) Tax Base

Taxable income is determined with reference to accounting profits, adjusted for tax purposes. The Accountancy Law, introduced in 1991 and last amended in 2000, is based on Western European models. Inventory may be valued using the FIFO method, the LIFO method, the weighted average cost method, or another approved method, provided the company consistently uses the same method.

d) Inclusions in Income

Capital gains from the disposal of the company's fixed assets are treated as part of its normal business income and capital losses are treated in the same way as other losses. For capital gains on the disposal of immovable property, the acquisition cost is adjusted for inflation.

e) Deductions

A taxpayer is allowed to deduct all expenses incurred in earning profits, other than items that are specifically disallowed. Disallowed expenses include expenses that may be depreciated; life insurance

premiums; the cost of fringe benefits provided to employees; expenses that are in effect distributions to shareholders or partners; funds transferred to reserves except for permitted provisions for bad debts; interest on loans from shareholders, where the shareholder has not fully paid his share of the capital; interest on loans to the extent disallowed by thin capitalisation rules; expenses in transactions with related parties where a transfer pricing adjustment is made; expenses of a personal consumption nature; taxes, fines and penalties; any other expense, the amount of which is not verified or supported by documentation. In addition, as noted above, the municipal tax is allowed as a deduction for central government tax purposes.

f) Depreciation

Depreciation allowances may be claimed for tangible and intangible assets. The straight-line method of depreciation is used, with four classes of assets for depreciation purposes. The classes and corresponding straight-line rates are as follows:

- Class I: buildings, structures, electricity lines, etc. (at 4%).
- Class II: machinery, manufacturing equipment, etc. (including computers) (at 20%).
- Class III: transportation vehicles, excluding automobiles (at 8%).
- Class IV: all other depreciable assets (at 15%).

In the case of Class II assets, as well as certain other assets (e.g. electricity carriers, communications lines, pipelines), taxpayers may elect to use the declining-balance method by applying a coefficient of up to 1.5 to the standard rate.[1] Depreciation is mandatory. No adjustments are made for inflation, although assets were revalued for depreciation purposes in 1997, since when the rate of inflation has been relatively low.

e) Losses

Net operating losses may be carried forward for five years (ten years in the case of banks), except in the case of a change of ownership of the company. No loss carry-back is permitted.

f) Dividends

Dividends received from a Bulgarian-resident company are not included in taxable profits. Dividends received from a non-resident company are taxable, with a credit for foreign tax paid (see below). A Bulgarian company paying a dividend (except to another Bulgarian company) is required to withhold tax at 15% (or the lower treaty rate, if applicable). For individuals resident in Bulgaria, the 15% withholding tax is a final tax.

g) Anti-Avoidance Provisions

Bulgaria has a general anti-avoidance provision, allowing the tax authorities to determine tax liability without regard to a transaction undertaken with the purpose of avoiding tax.

A thin-capitalisation rule applies if a company's debt financing exceeds twice its equity. In that case, the deductible amount of interest (on all loans other than bank loans, effective as of 2002) is restricted to the amount of interest received by the (debtor) company, plus 75% of its profits for the year (computed without taking account of interest paid or received). The rule is not restricted to loans from related persons, and does not apply to banks or holding companies.

Transfer pricing adjustments may be made in respect of transactions with related persons. Adjustments may also be made in computing the taxable income of branches of non-residents. The practical application of the transfer pricing provisions is problematic and there are no published guidelines to support the implementation of the provisions, which have been applied on only a few occasions.

There is no controlled foreign company (CFC) legislation.

3. International Aspects

a) Foreign Tax Credit

Bulgarian tax law allows a unilateral credit for foreign (withholding and branch profits) tax paid on income included in the taxable income of Bulgarian residents. The credit is calculated on a per-country basis. In the case of dividends from foreign companies the credit extends only to withholding tax. Where a tax treaty applies, however, there may also be a credit for underlying corporation tax or an outright exemption.

The Bulgarian approach to double taxation relief is unusual a reciprocity principle is applied, so that relief may be either by the credit method or by exemption, depending on the method employed by the treaty partner. The result is a somewhat complex system.

b) Non-resident withholding

A 15% withholding tax is levied on dividends, interest, royalties, rents and fees for technical services paid to non-residents. The withholding tax rate may be reduced by treaty: the relevant treaty withholding rates are as follows:

- Direct dividends:
  0% in the cases of Austria, Malta, and the Slovak Republic.
  5% in the cases of Albania, Armenia, Croatia, Cyprus, Denmark, France, Ireland, North Korea, South Korea, Luxembourg, FYR Macedonia, Moldova, the Netherlands, Singapore, Spain, Switzerland, Ukraine and Yugoslavia (FR).
  7% in the case of Morocco.
  10% in the cases of Belarus, Belgium, Canada, China, the Czech Republic, Finland, Georgia, Greece, Hungary, Italy, Japan, Kazakhstan, Poland, Portugal, Romania, Sweden, Turkey, the United Kingdom, Zimbabwe.
  15% in all other cases.

- Portfolio dividends:
  0% in the cases of Austria, Malta, and the Slovak Republic.
  5% in the cases of Croatia and Singapore.
  10% in the cases of Armenia, Belarus, Belgium, China, Cyprus, Czech Republic, Finland, Georgia, Greece, Hungary, Ireland, Italy, Kazakhstan, North Korea, South Korea, Morocco, Poland, Sweden, the United Kingdom.
  15% in all other cases, except Zimbabwe (20%).

- Interest:
  0% in the cases of Austria, Denmark, Finland, France, Germany, Italy, Malta, the Netherlands, Norway, the Slovak Republic, Spain, Sweden, the United Kingdom.
  5% in the cases of Croatia, Ireland, Singapore.
  7% in the case of Cyprus.
  10% in other treaty cases, except India, Romania and Russia (15%).

- Royalties:
  0% in the cases of Austria, Croatia, Denmark, Finland, Norway, the Slovak Republic, Spain, the United Kingdom.
  5% in the cases of Belgium, France, Germany, Italy, North Korea, South Korea, Luxembourg, the Netherlands, Poland, Singapore, Sweden, Switzerland.
  10% in other treaty cases, except India, Romania, Russia and Vietnam (15%).

In 2000, Bulgaria revoked its tax treaty with Cyprus in an attempt to eliminate various abuses. Cyprus has been the third largest source of foreign investment in Bulgaria, and some 250 companies registered

under the "offshore" regime in Cyprus operate in Bulgaria. It is suspected that many of those companies are in fact Bulgarian-owned. A new treaty has been negotiated with Cyprus but has not yet entered into force.

4. Individual Income Tax

The current Personal Income Tax (PIT) Law was adopted in 1997 and came into effect on 1 January 1998. Residents of Bulgaria are taxed on their total worldwide income. Non-resident individuals are taxed only on Bulgarian-source income. There is no special tax regime for expatriates. Under earlier legislation, foreign experts were taxed only on their Bulgarian-source income, regardless of the length of their stay.

PIT is levied at progressive rates. Annual income in excess of the basic exemption amount (BGL 1320) is taxed at rates rising from 18% to a top rate of 29%, on incomes in excess of BGL 12,000.

Income from business (sole proprietorships) is taxed under the PIT, taxable income being computed according to the provisions of the CIT. In the case of some business activities, however, a special annual lump-sum tax (the «patent tax») applies provided that the previous year's turnover was less than BGL 75,000. The patent tax is determined taking account of various factors (e.g. location, number of employees).

Dividends from resident companies are subject to a final withholding tax of 15%, while interest (other than certain types of exempt interest) is subject to final withholding tax at 20%.

5. Social Security Contributions

A new social security system came into effect at the beginning of 2000. Three funds were established – a Pension Fund, Sickness and Maternity Fund, and Labour Accident and Vocational Sickness Fund. These funds supplement the existing Unemployment Fund and Health Insurance Fund. The combined employer social security contribution rate is 34%, levied on gross salaries, subject to a ceiling equal to 10 times minimum wage), while the employee rate is 8%. There are no special rules for expatriates.

6. Consumption Taxes

VAT was introduced in 1994. That legislation was replaced by the VAT Law of 23 December 1998, which entered into force in 1999. The law is based closely on the (EC) sixth directive. The standard rate is 20%, with a zero rate applied to exports. New regulations governing VAT refunds were adopted in April 2001, and the most recent budget reduced the period within which refunds must be made, from four to three months. There are the usual excise taxes on alcohol, mineral oils and tobacco as well as a few other items, such as coffee, perfumes and motor vehicles. A special excise tax applies to gambling activities.

7. Import Duties

A new Customs Law and regulations came into effect on 1 January 1999. The new legislation follows the EC Customs Code. Imports are subject to duty according to their classification in the (Brussels) harmonised system, with rates ranging from 3% to 40%. Bulgaria has undertaken to progressively reduce its rates over a period extending to 2006.

Bulgaria's "Europe Agreement" with the EU provides for the elimination of import duties on manufactured products by 2002, as do agreements with EFTA and several other countries.

8. Other Taxes

There are a number of miscellaneous taxes, such as stamp duties and motor vehicle taxes. Property tax is levied on the owners of land and buildings.

C. Investment Incentives

Since 1990, Bulgaria has introduced and repealed a bewildering variety of tax incentives, with provisions under both the foreign investment laws and the tax laws. Indeed, almost every year from 1993 onwards, changes have been made to the rules governing tax incentives. The significant and frequent changes have been cited as contributing to investor uncertainty and adding to perceived investment risks.

However, since the major reforms at the end of 1997, the tendency has been towards the elimination of incentives, the broadening of the tax base, and the reduction in the statutory rates of tax. The following reviews incentives in 2001. A review of principal incentives employed in the recent past is given in a subsequent section on experience with tax incentives.

1. *Expenditure-based incentives*

- *Investment tax credit (regional)* – Bulgaria introduced an investment tax credit in 1999 to replace the priority project incentive (see below), to encourage investment in areas of high unemployment. The credit is earned at the rate of 10% on capital of domestic or foreign investors used for the acquisition, improvement, modernisation or reconstruction of long-term assets (e.g. communications equipment, electricity carriers, buildings, facilities). The investment must be in regions where the unemployment rate for the preceding two years exceeds 1.5 times the average for the country. Additionally, there is a source of funds requirement: the investment must be financed by new equity (i.e. capital contributions to existing corporations (new share issues), and new share capital raised upon incorporation). Unused credits may be carried forward for up to 5 years.
- *Accelerated depreciation* – the provision (described in section 2) whereby a taxpayer may depreciate certain (Class II) machinery and equipment types on a declining balance basis, at 30% (rather than on a straight-line basis at 20%), is sometimes described by commentators as "accelerated depreciation" (by international standards, however, this treatment it is not especially generous).

2. *Zone incentives*

Free trade zones were established in Bulgaria in 1987. There are now six such zones in operation – in Burgas, Dragoman, Plovdiv, Ruse, Svilengrad and Vidin. A seventh was established some years ago in Petrich, but never became operative. All of the zones, owned and operated by state-owned companies, are used primarily for import-export activities, for warehousing and distribution, with limited processing. Some manufacturing takes place in the Plovdiv and Ruse zones. The zones have attracted a number of foreign investors.

Imports into the zones are exempt from VAT and customs duty, with the zones not considered part of the customs territory of Bulgaria. Firms established in the zones are permitted to sell their products within Bulgaria, but only on payment of customs duty and VAT (i.e., goods are treated as imported into Bulgaria from the zones).

3. *General Experience with Investment Incentives*

As noted, the Bulgarian tax incentive framework has been subject to extension revision in the recent past. A partial summary of recent incentives follows:

a) Profit-based incentives

- *Preferential CIT rate (foreign firms)* – under the original 1992 foreign investment law, companies with more than 50% foreign participation and more than $100,000 capital contribution were taxed at a reduced rate of 30%, rather than the (then) standard CIT rate of 45%. This privilege was dropped in October 1993, by which time the standard CIT rate had been lowered to 40%. Companies registered before that date continued to enjoy the preferential 30% tax rate indefinitely, until the standard rate fell to 30% in 1998.

- *Tax holiday* – new tax holiday provisions were introduced in July, 1996, applying to companies that were at least 50% foreign-owned, with a capital of U.S. $5 million in fixed assets. Qualifying firms were provided with a full profit exemption for a period of three years, followed by a 50% profit exemption for a further two years. Qualifying companies were required to reinvest at least 50% of their tax saving in tangible fixed assets.[2]

A similar tax holiday was granted to companies in which the share of state or municipal ownership had been reduced to 33% as a result of privatisation. Various conditions were attached. In particular, all shares had to be paid for in cash, and qualifying companies were required to a) comply with the investment and employment rules of the framework of the privatisation programme; and b) reinvest at least 50% of the tax saving; and c) increase their annual net sales revenue (this condition was removed in 1997).

These holidays replaced earlier provisions, eliminated as of October 1993, that provided a five-year tax holiday (full profit exemption) for investments in high technology (granted on a case-by-case basis), agriculture, food processing or activities performed in duty-free zones.

- *Partial profit exemption* – the Foreign Investments Law of 1997 introduced a new incentive for "priority investment projects", giving foreign and domestic investors in priority projects a 50% profit exemption (from corporate income tax) for a period of ten years. Priority projects were defined as those that introduced advanced technology worth at least $5 million, created at least 100 new jobs, or were made in areas of high unemployment with poorly developed infrastructure. The government was required to publish a list of the eligible regions, and update that list each year. The incentive was eliminated in 1999, with existing eligible projects granted the right to retain their privileges until the end of the prescribed period. It seems that few if any investments were ever granted priority status.

b) VAT and customs duty incentives

Over the years various incentives have been introduced or modified, providing exemption from VAT and customs duties on the importation of machinery, technological equipment, and other contributions in kind to a firm's charter capital. Currently, no special VAT or customs duties reliefs are provided outside zones.

4. *Zone incentives*

Until 1993, foreign investors in the free-trade zones enjoyed five-year tax holiday (100% or full exemption from CIT). That regime was abolished, but existing zone enterprises were allowed to retain their privileges for the remainder of the five-year term.

Overall, the various incentives outlined above have been changed with such frequency that it would be virtually impossible to make any assessment of their effectiveness. They have also often been poorly drafted. When eliminating existing incentives, the Bulgarian Government has generally been careful to preserve the rights of investors by allowing them to retain their existing privileges. (There is also a general guarantee against adverse changes in the legislation.) However, since repealed incentives have usually been replaced by others, this gives rise to considerable uncertainty as well as to opportunities for "cherry picking". If anything, one would expect that the frequency of the changes and the resulting uncertainty would have acted as a deterrent to investment rather than as an incentive. A 1998 FIAS report concluded that the incentives had been mostly ineffective, open to abuse, unnecessarily complicated, and almost impossible to administer.

D. Postscript

During 2001, the Bulgarian Government announced its intention to introduce a 0% CIT rate on retained earnings. The introduction of the new system was postponed, on the advice of the IMF, because of the fear of creating too severe a shortfall in revenue. A number of important tax measures apply from January 2002:

- The basic central government CIT rate was reduced from 20% to 15%. The combined central and municipal rate becomes 23.5%. Small businesses, which were previously taxed at a lower rate, are now taxed at the same combined rate of 23.5%.
- The top personal income tax rate was reduced from 38% to 29%.
- In 2002 a special scheme was introduced for travel agents providing an effective VAT rate of 7% for tourist services provided to foreigners.
- The 2002 budget modified the 10% investment tax credit targeted at high unemployment areas. Under the new rules, the credit is earned on investments (financed by new share issue) in long- and short-term assets (including machinery, equipment, and computers). The reference period for the average unemployment rate in the country is shortened to two years. Moreover, the financial result before adjustment for tax purposes is further decreased with the compulsory employer social insurance contributions in proportion to the number of new jobs created (relative to the number of existing jobs). A five-year carry-forward continues to apply to unused credits.

NOTES

1. The draft of the CIT Act to come into force as of 1 January 2003 provides for the annual depreciation rate for tax purposes to be increased to 50% concerning computers and software, and to 10% for vehicles excluding automobiles.

2. Thus the tax incentive was 50% expenditure-based, and 50% profit-based (not tied to investment).

Chapter 10.

CROATIA

A. Foreign Investment

The previous Foreign Investment Law was replaced in 1995 by a new Companies Act. The law applies equally to domestic and foreign investors, who may establish any form of enterprise recognised by the law, whether wholly foreign-owned or in joint venture with a local partner. No formal approval is now required for foreign investments, except in a limited number of sectors such as banking, insurance and investment funds. Registration in the commercial register is required, as it is for domestic businesses. Some sectors, in particular natural resources, remain under state control and are subject to a "concessions" system, where concessions may be granted to domestic and foreign persons under equal conditions.

There are few restrictions on the ownership of immovable property, and in general, a foreign entity engaged in any business activity in Croatia may own real property without limitations. The Constitution guarantees the rights to repatriate capital and to transfer business profits abroad in convertible currency. It also strictly limits the right of the state to expropriate property and requires adequate compensation to be paid. Croatia has entered into bilateral investment protection treaties with a number of countries, and further agreements are in preparation with Austria, Germany, Italy and the United States.

Investor disputes may be referred to the regular courts or to arbitration. However, the Croatian court system is described as "cumbersome and inefficient" and "plagued by bureaucratic and funding problems" – apparently, as of February 2001, there was a backlog of 1.1 million cases. In practice, property rights have not been well protected in the past, although the situation is said to be improving.

The privatisation programme has been a mixed success, and a substantial number of large enterprises remain under state control. A number of serious allegations of fraud have been reported surrounding some of the privatisation deals under the previous government. Most of the privatisation activity to date has been in the banking and telecommunications sectors.

Summary statistics (2001)

Population: 4.4 million
GDP: $19.8 billion; GDP per capita: $4,505
Inward FDI flows: 2000: $1,126 mill.; 2001: $1,502 mill.; 1993–2001 (total): $6,704 mill.

B. Taxation

The overall level of taxation in Croatia is relatively high: in 1999, government expenditures amounted to 56 per cent of GDP. The principal taxes are the business profits tax, personal income tax, VAT, and excise duties. The tax system underwent a major reform at the end of 2000, the new rules coming into effect in January 2001.

1. *Corporate Income Tax*

Prior to the recent reforms, Croatia had a rather unusual system of CIT. The previous system, which was introduced in 1994, has been described as a form of cash-flow tax (a business consumption type tax). By allowing a deduction for "interest" imputed to corporate equity, the tax base was substantially narrower than under more conventional cash-flow models. As from 2001, it has been replaced by a new Business Profits Tax, which computes taxable profits according to the usual principles.

The business profits tax rate was reduced to 20%, as from 2001. Previously, the rate had been 35%, but the tax base was substantially narrower due to the deduction of an allowance for return on corporate equity. A deduction for depreciation is allowed, on a straight-line basis, and losses may be carried forward for up to five years.

Dividends paid to resident individuals are subject to a final withholding tax of 15%.

2. *International Aspects*

A resident company is taxable on its worldwide income and capital gains. Foreign-source dividends are not taxable in Croatia. A unilateral foreign tax credit is given to resident individuals and legal persons. Withholding taxes are levied on payments to non-residents: the non-treaty rate is 15% for dividends, interest, royalties, and certain other payments.

Croatia has entered into tax treaties with: Albania, Austria, Belgium, Bulgaria, Canada, China, Cyprus, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Lithuania, FYR Macedonia, Malta, the Netherlands, Norway, Poland, Romania, Russia, the Slovak Republic, South Africa, Sri Lanka, Sweden, Switzerland, Turkey, Ukraine, and the United Kingdom.

The treaties normally provide for a 5% withholding rate for dividends paid to related companies, although the treaty with Germany prescribes a 0% rate. Several of Croatia's treaties exempt interest and royalties from withholding tax.

3. *Individual Income Tax*

Croatia adopted a new personal income tax as from January 2001. Income tax is paid at progressive rates, rising from 15% to 35% (on income in excess of five times the basic personal allowance). Dividends are subject to a final withholding tax of 15%, and interest to a final withholding tax of 35%. Income tax is increased by the surcharges imposed by cities.

4. *Social Security Contributions*

No payroll taxes are imposed on companies. Employers are required to pay social security contributions at a combined rate of around 17% on gross wages and salaries, while employees contribute 21% on the same base.

5. *Consumption Taxes*

VAT is levied at a single rate of 22%. A small number of items are zero-rated. Excise tax is levied on alcohol, non-alcoholic drinks, beer, tobacco products, new cars, oil products, coffee and some luxury goods.

6. *Import Duties*

In 2001, Croatia entered into a Stabilisation and Association Agreement with the EU which provides for the progressive elimination of duties on products imported from EU countries.

7. *Other Taxes*

Other taxes include a land transfer tax, motor vehicle tax, advertising tax, and local taxes.

C. Investment Incentives

Investors in Croatia (foreign and domestic) benefit from the following incentives in 2001

1. *Expenditure-based incentives*

- *Accelerated depreciation* – normal depreciation rates are doubled for investments in certain qualifying tangible and intangible assets (normal rates for machinery and equipment range between 5 and 25%, while the normal rate for intangibles is 20%).

2. *Profit-based incentives*

- *Tax holidays* – a full exemption from profit tax is given on investments of $7 million or more, provided that at least 75 jobs are created and maintained. The tax holiday is for ten years, and begins in the year in which the investment project is initiated.
- *Preferential tax rates* – reduced profit tax rates may apply (7% and 3%), for a period of ten years, depending on the level of investment and the number of jobs created. Preferential tax rates also apply in certain parts of the country that suffered major damage during the war, and have been designated as areas of special national concern.

3. *Customs duty incentives*

- *Customs duty exemption* – an exemption from customs duty is provided on imports of equipment as capital contributions to a new investment.

4. *Zone incentives*

- *Free trade zones* – a new Law on Free Trade Zones was enacted in June 1996, replacing the earlier law. Economic activities which may be carried on in a free trade zone include manufacture and processing of goods, provision of services, banking and other financial operations, and wholesale trade: retail trade is not permitted. In 1997, the government announced the creation of new free trade zones (FTZs) at the ports of Rijeka, Sibenik and Balcar. A free zone has also been established in Vukovar. Zone enterprises enjoy a number of tax privileges:

– *Tax holiday* – five-year tax holiday (for large investments).
– *Profits tax exemption* – a profit tax exemption of 50%, following the tax holiday.
– *Customs duty exemption* – customs duty exemption on stored or used in a zone.

Chapter 11

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

A. Foreign Investment

1. *The Environment for FDI*

The former Yugoslav Republic of Macedonia (FYR Macedonia) achieved full sovereignty and independence in 1991, and immediately embarked upon a programme of economic reform and liberalisation. A Foreign Investment Law was adopted on May 12, 1993, establishing the legal framework for foreign investment.

FYR Macedonia has had difficulty attracting substantial amounts of FDI, for a variety of reasons. The country is relatively isolated and landlocked, its physical infrastructure is poor, and the domestic market is small. In addition, the overall situation in the region has been highly unstable for most of the country's existence mainly due to the security crisis following the dissolution of former Yugoslavia. Political instability has largely affected the economic growth of the country. Over the years, Macedonia's relations with Greece have improved to the extent that Greece has become its largest source of FDI. Conflict in neighbouring Kosovo broke out in 1999 and soon after its end Macedonia itself was dragged into a security crisis which further deteriorated the economic prospects of the country. However, Indications are that stability has been restored and that foreign investment has started to flow again. A substantial amount of FDI was promised when FYR Macedonia recognised Chinese Taipei in 1999. However, a change of policy in 2001 and the recognition of the Peoples' Republic of China led to the cancellation of various Taiwanese aid and investment projects.

Macedonia has a liberal foreign investment environment, with few legal and regulatory obstacles to FDI. Apart from the recurring instability, the problems most often cited by foreign investors are a cumbersome bureaucracy, inconsistencies in legislation, inadequacy of law enforcement, non-transparent procedures, an undeveloped banking system, and a large "grey" economy. A World Bank report based on a 1999 survey of enterprise managers found a relatively high level of corruption of public officials to avoid taxes and regulations. Smuggling was also prevalent, largely due to the external situation. However, the Macedonian Government has been co-operating with various international bodies to combat corruption and has adopted a number of legislative measures to that end.

Summary statistics (2001)

Population: 2.0 million
GDP: $3.4 billion; GDP per capita: $1,723
Inward FDI flows: 2000: $176 mill.; 2001: $442 mill.; 1993–2001 (total): $823 mill.

2. *The Regulation of Foreign Investment*

Foreign investment in FYR Macedonia was initially regulated by the Foreign Investment Law of 1993, which was replaced in 1996 by the Law on Trading Companies. Under the new law, no differentiation is made between domestic and foreign persons.

a) Restrictions on FDI

Foreign investors may invest in Macedonian enterprises, enter into joint ventures, or establish a separate (wholly-owned) enterprise in the same manner and under the same conditions as domestic persons. Investment is permitted in almost all sectors of the economy, and only limited restrictions are imposed (e.g. military and weapons production, circulation and trade of narcotics). A special licence is required to engage in those activities (which are mostly of a public or social nature) regulated by the Concessions Law. There are no local equity requirements for investors and 100 per cent foreign-owned enterprises are permitted.

There are no restrictions imposed on foreign investments in the banking sector. The banking sector is regulated by the Law on Banks (Official gazette No. 63.00).

b) Approval and Licensing

The 1996 Law has removed the earlier requirement that investment contracts, joint venture contracts, or the foundation documents of wholly foreign-owned enterprises be submitted to the Ministry of Foreign Affairs, and there is no special approval procedure.

c) Forms of Doing Business

Foreign investors may establish a company (limited liability company or joint stock company), or acquire shares in an existing Macedonian company, under the same conditions as domestic investors. Prior to 2000, the law required that at least one director be Macedonian (that requirement has now been removed) The establishment of a branch or representative office requires the approval of the Ministry of Foreign Affairs.

d) Property Rights

The 1991 Constitution guarantees the right to own property. With a few exceptions, this right applies equally to foreign investors. No person may be deprived of property except in accordance with the law. The Constitution and the Expropriation Law of 1995 provide that, in the event of expropriation, the owner will be compensated at market value. Foreign investors are allowed to own buildings and business premises, but the right to own land is restricted to land required for the purposes of the business.

Rights conferred by the Foreign Investment Law cannot be removed or restricted by any other law or regulation. Where a law is subsequently amended, the foreign investment will continue to be subject to the law in force at the time it was made if the prior law was more favourable. Macedonia has signed bilateral investment agreements with Croatia, Turkey, FR Yugoslavia, Poland, Italy, China, the Russian Federation, Albania, Sweden, Ukraine, Slovenia, the Netherlands, Bulgaria, France, Egypt, Switzerland, Iran, Finland, Hungary, Germany, Malaysia, Korea, Belgium, Luxemburg, the Czech Republic, United Kingdom, Ireland, Uzbekistan and Belarus.

e) Foreign Exchange

The Foreign Investment Law stipulates that a foreign investor has the right to freely transfer or reinvest profits, and to repatriate capital or assets on the liquidation of the investment. The *denar* is fully convertible and is pegged to the Euro.

f) Import and Export

FYR Macedonia is preparing for membership of the WTO, and was the first country in the region to sign the Stabilisation and Association Agreement with the EU, in April 2001. Free trade agreements have been concluded with Bulgaria, Croatia, and Slovenia. Import restrictions were lifted in 1996, but there are restrictions on the export of a few raw materials and of agricultural equipment.

g) Dispute Resolution

Investor disputes can be settled before the courts or be referred to arbitration, either in FYR Macedonia or abroad. In the past there have been complaints about the inadequacy of law enforcement and occasional instances of corruption. According to the U.S. Department of State, "the court system is still developing and is sometimes slow and cumbersome." Macedonia recognises foreign arbitral awards and is a party to the ICSID convention.

3. *Privatisation*

Privatisation in FYR Macedonia began in 1989. Since 1993, it has been carried out under the Law on Transformation of Enterprises with Social Capital, with supervision by the Privatisation Agency. Privatisation has been carried out on a case-by-case basis, using a variety of methods, the most common being management buyouts and employee buyouts. The law also permits the sale of all of the assets of an enterprise, this method being preferred where foreign investment is sought. By mid-2001 a total of 1,646 enterprises had been privatised, and the process had been almost completed.

The two largest foreign investments in Macedonia have taken the form of privatisation. In 2000, the National Bank of Greece acquired a 68% stake in Stopanska Banka, Macedonia's largest bank, for $53 million, and early in 2001, Hungary's Matav (controlled by Deutsche Telekom) paid over $300 million for a controlling share in MakTel, the leading telecom operator. This latter investment almost equalled the total FDI in Macedonia (FYR) for the previous 10 years.

B. Taxation

The overall level of taxation, and of government expenditure, is moderate by European standards. The projections for 2002 are that revenues will amount to 33.4% of GDP, and that expenditures will be 36.8%. In 2000, tax revenues were made up as follows:

- Corporate income tax 3%.
- Personal income tax 13%.
- Social security taxes 37%.
- Taxes on goods and services 37%.
- Taxes on international trade 10%.

1. *The Tax System*

a) Formulation of Tax Policy

The Ministry of Finance has the primary responsibility for formulating tax policy and drafting tax legislation. The government proposes laws, which must be adopted by the parliament. Parliament may amend proposed laws but has no power to propose laws itself.

b) Budget Procedure

The budget is prepared by the Ministry of Finance. Annual budgets explain and clarify fiscal objectives and their sustainability. Fiscal projections are made in co-operation with the National Bank of Macedonia and with the State Statistics Bureau. They are not subject to independent review. No estimate is made of tax expenditures.

c) Administration and Control

The Ministry of Finance is responsible for tax administration, with a Public Revenue Office, divided into a general directorate, regional directorates and tax departments. Sub-central levels of government

do not have taxing powers but assist in the administration and collection of some taxes, notably the property tax.

In 2000, the legal framework for financial control was revised with the introduction of new legislation, including a Law on Budgets. Supervision of government departments is exercised by the government under the Law on State Administrative Bodies. The ministries themselves conduct their own internal audits and can request outside bodies (e.g. the large accounting firms) to assist in the audit procedure. (The internal audit division of the Ministry of Finance was established in September 2000.) The State Audit Bureau is the supreme auditing institution and examines internal ministry audits and the use of state expenditures.

There is no provision for statutory audits and taxpayers are audited at random. Fines may be imposed and tax evasion may be punished by imprisonment for up to five years.

2. *Corporate Income Tax*

Companies are taxed under the Profits Tax Law of 1993, which has been amended a number of times since then, most notably in December 1996. The system of taxing companies and their shareholders is something of a cross between the classical and imputation systems. Companies are taxed on their profits and, when paying dividends to resident individual shareholders, must withhold tax at the normal withholding rate of 15%, but only on one-half of the dividend (implying an effective withholding tax rate of 7.5%, with the reduction presumably in recognition of the taxation of profits at the company level). The shareholder includes the full amount of the dividend in taxable income but is allowed a credit for the tax withheld.

Dividends paid to another resident company are not subject to withholding and are tax-free in the hands of the recipient.

a) Taxpayers

The Profits Tax is imposed on the worldwide profits of all resident companies and on the profits of non-resident companies derived from business activities carried on in FYR Macedonia. A company is resident in Macedonia if it is incorporated there or has its head office there. A group of companies may request that it be treated as a single entity if the parent company and its subsidiaries are all resident in FYR Macedonia and at least 90% of the shares of each company are in common control.

Individuals who carry on business as sole proprietors are taxed under the Personal Income Tax Law, but their business income is calculated according to the provisions of the Profits Tax Law. Individual partners in registered partnerships pay income tax on their shares of the partnership profits (i.e. partnerships are fiscally transparent).

b) Tax Rate

Profits Tax is levied at the rate of 15%, with the rate lowered from 30% in 1996.

c) Tax Base

Taxable income is the accounting profits, defined by the Accounting Law, adjusted for tax purposes. Inventory is valued using the average cost method.

d) Inclusions in Income

Capital gains on the disposal of securities, equipment and real estate are included in taxable profit, although such gains are mostly exempt until 2006. Losses on such disposals are set off against other capital gains and, and if not utilised in full, may be carried forward for up to three years.

e) Deductions

The general rule is that expenses incurred in earning profits are deductible, other than those items that are specifically disallowed. Disallowed expenses include: allocations to reserves, except as expressly allowed (e.g. for banks and insurance companies); advertising, promotion or entertainment expenses in excess of 3% of turnover; and fines and penalties.

f) Depreciation

Depreciation may be deducted in accordance with the accounting regulations. There are 14 depreciation classes and 89 categories of depreciable property. Either the straight-line or the declining balance method may be used, but once chosen it must be used consistently. There is also a method referred to as the "functional method" which may be used for some types of assets (e.g. depreciation for certain vehicles may be based on mileage), with the consent of the public revenue office.

Depreciation is inflation adjusted, depreciable assets being revalued annually in accordance with the inflation index. The basis for depreciation is not reduced by any investment allowance (see below, under "Incentives"). Depreciation deductions are mandatory.

g) Losses

Losses may be carried forward for three years, except in the case of merger or a change of ownership of the company. No loss carry-back is permitted.

h) Dividends

Dividends received from a company resident in FYR Macedonia are not included in taxable profits provided profit tax has been paid by the distributing company. Dividends received from a non-resident company are taxable, and double taxation relief in respect of underlying corporate income tax is available only under a treaty provision (see below).

A resident company paying a dividend to a resident individual must withhold tax at an effective rate of 7.5% (15% on one-half of the dividend). No tax is withheld on dividends to resident companies or to a non-resident company, but dividends to non-resident individuals are subject to withholding tax at the effective rate of 7.5%.

i) Anti-Avoidance Provisions

There is no general anti-avoidance provision, and no thin capitalisation rules. Interest paid to connected persons may only be deducted up to the market rate. Transfer pricing adjustments may be made, using the "arm's length" method, in transactions with connected persons.

3. *International Aspects*

a) Foreign Tax Credit

A unilateral foreign tax credit is given for withholding tax and foreign branch profits tax. Indirect foreign tax credits may also be claimed under the provisions of an applicable treaty.

b) Withholding

A 15% withholding tax is levied on (one-half of) dividends, interest, royalties, rents and fees for technical services paid to non-resident individuals. There is no withholding tax on most types of payment to non-

resident companies. The withholding tax rate (on payments to individuals) may be reduced by treaty. The relevant treaty withholding rates are:

- Portfolio dividends:
  10% in the cases of China-Taiwan, Egypt, Hungary, Iran, Russia, and Turkey;
  15% in other cases [i.e. Belgium, the Czech-Republic, Croatia, Denmark, Finland, France, Germany, Hungary, the Netherlands, Romania, Slovenia, Sweden, Switzerland, FR Yugoslavia].

- Interest:
  0% in the cases of the Czech Republic, Denmark, France, Hungary, the Netherlands;
  10% in other cases, except Belgium (15%).

- Royalties:
  0% in the cases of France, Finland, Hungary, Italy, the Netherlands, Sweden, Switzerland;
  10% in other cases.

Treaties have also been negotiated with Albania, Bulgaria, Poland, Russia and Ukraine. (New treaties have been negotiated with Denmark and France to replace the old treaties – with FR Yugoslavia – that were applied to FYR Macedonia.)

4. Individual Income Tax

The Personal Income Tax (PIT) Law was adopted in 1993 and has been amended several times since then. Residents of FYR Macedonia are taxed on their total worldwide income, while non-resident individuals are taxed only on income earned in Macedonia.

There are now two rates of tax: 15% and, for income in excess of MKD 360,000, 18%. Prior to 1997 the top rate had been 35%. Income from agriculture is taxed separately under a cadastral tax.

5. Social Security Contributions

Employer social security contributions are made at a rate of 32% of salaries, and there is no cap. Employers must pay contributions for expatriate employees.

6. Consumption Taxes

a) Value-Added Tax

VAT was introduced in 2000. The law is based closely on the (EC) sixth directive. The standard rate is 19%, with a reduced rate of 5% for most food and agricultural products and for some other items. VAT refunds are made on request and must be made within one month.

b) Excise Taxes

There are the usual excise taxes on alcohol, mineral oils and tobacco as well as on coffee and some luxury items.

7. Import Duties

A new customs tariff, consistent with EU and international standards, was introduced in 1996. FYR Macedonia has an association agreement with the EC, is a member of EFTA, and proposes to join the WTO and CEFTA. It has also entered into a number of free trade agreements with other countries.

8. *Other Taxes*

Property tax is levied on the owners of land and buildings, except where used for agricultural purposes. The property tax also applies to motor vehicles. (The property tax law also taxes gifts and inheritances.) A separate tax applies to the transfer of land and buildings.

C. Investment Incentives

FYR Macedonia provides a number of generous incentives for investors in 2001, some of them restricted to foreign investment. Granting of tax incentives is normally automatic where the prescribed conditions are met.

1. *Expenditure-based incentives*

- *Investment allowance (general)* – an investment allowance is provided as an offset to taxable profit, earned at a 100% rate on investment in qualifying fixed assets (assets used to expand the taxpayer's business, but excluding automobiles, furniture and other listed assets). The allowance does not affect the depreciation basis of the assets. The investment allowance is capped at 25% of taxable profit.
- *Investment allowance (regional)* – an investment allowance is provided as an offset to taxable profit, earned at a 100% rate on investment in qualifying assets used in certain economically depressed regions and municipalities. The allowance is capped at 50% of taxable profit. The allowance does not affect the depreciation basis of the assets.
- *Investment allowance (environment)* – an investment allowance is provided as an offset to taxable profit, earned at a 100% rate on investment in qualifying assets acquired for environmental protection. The allowance is not capped and does not affect the depreciation basis of the assets.
- *Accelerated depreciation* – accelerated depreciation may be claimed for investment made for the purpose of technological modernisation or environmental protection, up to an amount 25% higher than the normal depreciation deduction. Accelerated depreciation may be claimed at the same time as an investment allowance.

2. *Profit-based incentives*

- *Tax holiday* – newly established companies satisfying a foreign participation threshold (minimum of 20% of total capital) are entitled to a three-year profit exemption proportionate to the percentage of foreign ownership, commending in the first tax year in which they generate profits. Companies that are 100% foreign-owned enjoy a complete tax holiday (full profit exemption) for three years (companies 50% owned by non-residents have 50% of profits exempt from corporate tax). An investor that is granted the exemption must carry on business in FYR Macedonia for a period of at least three years following the period during which the exemption was granted.
- *"Listed" profit exemption* – companies listed on the Macedonian Stock Exchange receive a 50% profit exemption until 21 December 2005.
- *"First-time" profit exemption* – investors in newly established unincorporated businesses undertaking business activities in Macedonia for the first time are entitled to a 50% profit exemption in the first year in which the taxpayer (self-employed individual) realises a profit (the profit exemption applies to personal income tax). The profit exemption is conditional on the taxpayer carrying out his activity for at least three years from the day the application of the exemption begins.[1] (The taxpayer is also entitled to the investment allowance, up to 25% of the tax base).

3. *Expatriate incentives*

- *Personal income tax reduction for expatriates* – a 50% income exemption, against personal income tax, is provided for expatriate employees.

4. *Customs duty incentives*

- *Customs duty exemption* – an exemption from customs duty is granted for purchases of raw materials, depreciable assets and contributions in kind to a company's capital, provided that foreign participation in the company is not less than 20%, and the company's activities continue for at least three years after the exemption was granted. (There is no special VAT incentive, except in free economic zones).

5. *Zone incentives*

- *Free-trade zones* – Macedonian law provides for the establishment of "free economic zones". One such zone, the Skopje FEZ (at Bunardzic, 10 km. east of the capital) was established in July 1999, and three other zones have been planned.

Zone firms are offered a number of incentives, as follows:

- *Tax holiday* – a full exemption from profits tax for a period of ten years from the date of commencement of activities in the zone.
- *Investment allowance* – a profit tax allowance earned at a 100% rate on qualifying investments, after the end of the tax holiday period.
- VAT *and customs duty exemption* – for goods entering the zone (VAT and customs duty to be paid on goods entering FYR Macedonia from the zone).
- *Other tax exemptions* – exemption from property tax for a period of ten years from the date of commencement of activities in the zone; and exemption from transfer tax.

In order to qualify for these exemptions, zone firms are required to export at least 51% of their production in the first year of operation, rising to 70% in the third and subsequent years.

The Skopje FEZ was part of a development project funded by the government of Chinese Taipei and, although it was intended to be open to investors from other countries, it was assumed that most of the initial investors would be from Chinese Taipei (25 firms employing 8,000 people were envisaged). The project collapsed when the ties between FYR Macedonia and Chinese Taipei were severed, following Macedonia's re-establishment of the diplomatic relations with the Peoples' Republic of China. Construction of the zone ceased in June 2001 at which time it was reported to be "still largely an empty site". It has been temporarily used as a base for a NATO contingent.

6. *General Experience with Investment Incentives*

The low level of FDI in Macedonia demonstrates that even the most generous tax incentives are unlikely to be effective if other conditions are unfavourable to investment. The existing incentives would seem to be difficult to interpret and to apply in practice. There is some overlap between the different provisions and they appear to be cumulative (i.e. a taxpayer can claim a 50% tax reduction under one provision and an investment allowance under another, in the same year).

D. Postscript

A new law on Trading Companies was adopted in July 2002 and will become effective as of 1 July 2003, replacing the old Law on Trading Companies which had been enacted in 1996.

NOTE

1. Where the three-year milestone is not met, the taxpayer is obliged to pay the outstanding tax, revalued by the retail price index.

Chapter 12.

MOLDOVA

A. *Foreign Investment*

The Foreign Investment Law of Moldova was enacted in April 1992 and amended in 1994, 1996 and 1998. Work started in 2001 on drafting a new law on Investment Promotion, intended to apply to both foreign and domestic investment. The draft is now finished and in the process of being made law.

Moldova's attitude towards FDI is generally described as favourable and, with very limited exceptions, all sectors of the economy are open to foreign investment. Foreign investors are entitled to national treatment, and there are no restrictions on repatriating profits. Moldova has signed bilateral investment protection treaties with some 28 countries. Foreigners may own non-agricultural land. Complaints have been voiced relating to the slow, and sometimes costly, bureaucratic procedures involved in obtaining the necessary licenses to operate.

The Foreign Investment Law guarantees that, for a period of ten years from the date any new legislation enters into force, a foreign investment will continue to be governed by the law in force on the date of its establishment. It also expressly provides that tax and customs advantages will continue notwithstanding the adoption of new laws.

Despite the relatively attractive legal environment for FDI, actual investment in Moldova has been small. By the end of 2002, the total stock of FDI was about US$ 6393 million. Very little FDI has been in manufacturing (food processing accounts for about 20 per cent of the total).

Privatisation began in 1994, with a voucher system used during the first phase. The third programme (1997-98 and extended to 2000) involved only cash privatisation and was open to foreign investors. (In practice, because of the shortage of domestic capital, it is largely dependent on foreign investors.) Early in 2000, the parliament rejected plans for the privatisation of the important tobacco and wine industries, leading to a disagreement with the IMF and World Bank and resulting in the suspension of development aid. The problem was resolved in October of that year, when the Parliament voted in favour of the privatisation programme, but it was again suspended in 2001 following the change of government.

Summary statistics (2000)

Population: 4.3 million
GDP: $1.5 billion; GDP per capita: $344
Inward FDI flows: 2000: $143 million; 2001: $149 mill.; 1993–2001 (total): $620 mill.

B. Taxation

The present tax system in Moldova was introduced in 1992. In 1997, a new tax code was introduced, which entered into force on 1 January 1998. The code follows accepted international practice and was drafted with the assistance of foreign consultants. The code introduced some concepts that were unfamiliar to Moldovian

practitioners and officials, and have caused some controversy. The main problem, however, seems to be the lack of implementing regulations and uncertainty as to application.

1. *Corporate Income Tax*

The Profits Tax is of the classical type, with a final withholding tax on dividends. The basic rate was reduced (from 32 per cent) to 28 per cent in 1998, and further reduced in 1999 to 25 per cent. There appear to be no provisions for loss relief.

2. *International Aspects*

A unilateral foreign tax credit is given to resident individuals and legal persons in respect of foreign withholding tax and branch profits tax. Withholding taxes are levied on payments to non-residents. The non-treaty rates are as follows:

- Dividends 15%.
- Interest 15%.
- Royalties 20%.
- Management fees 20%.

Moldova has entered into double taxation treaties with 28 countries. The treaties with Austria, Cyprus, Finland and the United Kingdom provide for 0% withholding tax on dividends, interest and royalties. Interest is also exempt from withholding tax in the treaties with Denmark, Italy, the Netherlands, Norway, Russia and Spain.

3. *Individual Income Tax*

The Personal Income Tax, schedular in design, is rather complex. The top individual rate, which had been 50%, was reduced to 25% in 1999.

4. *Social Security Contributions*

Social insurance contributions are payable by employers. The rate varies according to the type of employer, but is normally 31% of the gross salary for most commercial enterprises.

5. *Consumption Taxes*

The VAT (which follows standard practice except in relation to transactions with Russia and other countries of the former Soviet Union) remains at 20 per cent. In addition, there are a number of excise duties.

6. *Import Duties*

The current Customs Code was adopted in March 1993. Rates of duty tend to be quite high.

7. *Other Taxes*

There is a tax on immovable property and a number of miscellaneous transaction taxes. Local authorities also impose a number of taxes, in particular property and real estate tax.

C. Investment Incentives

The Profits Tax Law and Foreign Investment Law provide exemptions and allowances for certain taxpayers and for certain activities. Available information indicates the following list of incentives:

1. *Profit-based incentives*

- *Tax holidays* – profit on qualifying investment is fully exempt from tax for a period of 1 to six years, depending on the type of products manufactured. To qualify, the investing enterprise must satisfy two criteria: (a) foreign participation must be at least 30% or, total investment must be at least US $ 250,000; and (b) more than 50% of the turnover must arise from the sale of its own manufactured products.

2. *Customs duty incentives*

- *Customs duty exemption* – assets imported by a foreign investor as part of its contribution to the share capital of a new enterprise, and assets intended for expansion of its existing production are exempt from customs duties.

- Goods imported by companies with foreign capital to Moldova for further processing and exporting are exempt from custom duties.

3. *Zone incentives*

- *Free enterprise zones* – six free enterprise zones exist in Moldova, five of which are operational. A new Law on Free Enterprise Zones was adopted in July 2001. The Chisinau FEZ is the only one in which there has been substantial investment, although most of that investment is in wholesale or retail trade (not normal types of activity carried on in a duty-free zone). The other zones were established between 1995-2000, and have few foreign investors, mostly engaged in the production of wine for export.

Moldova's FEZs resemble the usual export-processing zone, except that activities are not restricted to manufacturing and processing. Zone enterprises benefit from:

- Tax holiday (for large investment).
- Preferential corporate income tax rate.
- VAT and customs duty exemptions, except on sales made within Moldova.

D. Postscript

In March 2002, the Moldovian Government announced the adoption of a new investment strategy. The incentive package is planned to include:

- A reduction in the CIT rate to 15%;
- Introduction of tax holidays; and
- Reduction in VAT.

Since February 2002, the Export Promotion Organisation of Moldova (MEPO) is responsible for investment policies and promotion activities in Moldova. The Investment Promotion Department of MEPO will later on become the future Moldovian Investment Development Agency (MIDA). The former National Agency for Attracting Investments does not exist anymore.

Chapter 13.

ROMANIA

A. Foreign Investment

1. *The Environment for* FDI

Following the fall of the Ceausescu Government in December 1989, Romania initiated a programme of economic reform, including the promotion of foreign investment. Although successive governments have all been well disposed towards foreign investors, frequent policy changes, high inflation, and slow privatisation, together with the conflicts in neighbouring Yugoslavia, have produced a rather unstable environment which has deterred investment.

Tax laws, in particular, have changed with bewildering frequency. Most damaging was the "moratorium" announced in 1999, which removed many existing tax incentives that had already been granted to investors, followed only a few months later by the introduction of a completely new set of incentives. According to a 1999 FIAS report, the resulting instability "drastically eroded the government's credibility".

Apart from taxation, investors complain of complex and constantly changing regulations and an unwieldy bureaucracy. Corruption has been a problem in the past, investors complaining that the payment of bribes to public officials to avoid taxes and compliance with other regulations was common. However, in 1997 the government introduced a three-year programme to fight corruption in public institutions and the situation now seems to be improving.

Summary statistics (2001)

Population: 22.4 million
GDP: $39.7 billion; GDP per capita: $1,773
Inward FDI flows: 2000: $1,040 mill.; 2001: $1,137 mill.; 1993–2001 (total): $7,581 mill.

2. *The Regulation of Foreign Investment*

The legal framework for foreign investment in Romania has undergone significant reform in recent years. In the past, a number of different ministries and agencies had responsibilities for investment, creating some problems. From May 2000, that situation improved, with the National Agency for Regional Development (NARD) taking over the activities of the former Romanian Development Agency and the National Agency for Small and Medium-sized Enterprises. In January 2001, the government set up a new Department for the Liaison with Foreign Investors, which has embarked on a further liberalisation of regulatory requirements. In mid 2002, a new agency, the Romanian Agency for Foreign Investment (ARIS) ,has been established to assume responsibility for promoting FDI and dealing with international investors.

a) Restrictions on FDI

Foreign investment is permitted in all sectors of the economy, provided it does not violate environmental protection regulations, impair national defence or interests, or pose a threat to public regulations, health

or morality. According to some reports, obtaining approval under the environmental regulations can be a lengthy and difficult process, in part because of the shortage of competent experts in that field in Romania.

There are no local equity requirements for investors and 100 per cent foreign-owned enterprises are permitted in most sectors of the economy. In practice, the joint venture form is the most popular.

b) Approval and Licensing

Foreign investment projects must be registered with the NARD. The registration process is normally a formality (provided the relevant conditions are met) and is required to be completed within 30 days. (This requirement has been repealed).

c) Forms of Doing Business

Investors in Romania may carry on business in the form of a limited liability company (which can be formed with a single shareholder), a joint stock company, or a partnership (general, limited, or limited by shares). A foreign legal entity may also establish a branch in Romania. Foreign investment may also take the form of acquisition of part or all of the share capital of an existing Romanian company.

d) Property Rights

The Foreign Investment Law provides for national treatment for foreign investors, except with respect to land ownership. However, companies established in Romania, even with 100% foreign ownership, are entitled to own land. Patents, trademarks and industrial and intellectual property rights are protected by domestic legislation and by a number of international agreements to which Romania is a party. Whilst the legal framework for protecting intellectual property is generally satisfactory, enforcement of property rights has in the past been inadequate, especially against copyright and trademark infringement, and in 1999 Romania was placed on the U.S. "special 301 watch list". Software and video piracy have been especially problematic.

Romanian law guarantees foreign investors against expropriation or nationalisation except in the public interest, in which case prompt and just compensation must be paid. In addition, investors are guaranteed that their investment will be governed, for its duration, by the law in force at the time of its establishment.

Romania has entered into bilateral investment protection treaties with: Austria, Bangladesh, Belgium, Bulgaria, Cameroon, China, Cyprus, the Czech Republic, Denmark, Egypt, Finland, France, Gabon, Germany, Greece, Hungary, Israel, Italy, Jordan, Kuwait, Malaysia, Mauritius, Morocco, the Netherlands, Norway, Pakistan, Russia, Senegal, Sri Lanka, Sudan, Switzerland, Thailand, Tunisia, Turkey, the United Arab Emirates, the United Kingdom, the United States, Uruguay, and FR Yugoslavia.

e) Foreign Exchange

No restrictions are imposed on the conversion or transfer of funds associated with direct investment. Profits, proceeds from the sale of shares or liquidation of an investment, and compensation for expropriation, can be freely transferred abroad after payment of taxes. However, there are sometimes procedural delays in processing capital outflows.

f) Import and Export

Romania is a member of the WTO and CEFTA. According to the Association Agreement with the EU all customs duties and tariff restrictions on industrial goods were eliminated by 2002, an agreement with EFTA has similar conditions.

g) Dispute Resolution

Although property and contractual rights are recognised in law, investors have found that enforcement through the court system is often difficult, principally because judges lack experience of commercial practice. It is common for agreements between foreign investors and Romanian parties to provide for third-party arbitration. An International Commerce Arbitration Court has been established in Bucharest, administered by the Chamber of Commerce. Romania also recognises awards of foreign arbitral institutions and is a member of the ICSID convention.

3. Privatisation

Romania's privatisation has proceeded rather slowly, especially in the early reform years, and then seemed to slow down again after 1996. The EBRD *Transition Report* 2001 concluded that the privatisation of small companies was almost complete but that not much more than 25% of large-scale enterprises had been privatised. By the end of 2000, the private sector accounted for 60% of total GDP.

Foreign investors are permitted to participate in the process but have complained that the larger deals have frequently become bogged down by indecision within government ministries, and with problems created by environmental regulations.

B. *Taxation*

The overall level of taxation and of government expenditure in Romania is fairly average by European standards. In 1999, government expenditures amounted to 37.1% of GDP, while tax revenues stood at 33.3%. Central government revenues, for 2000, were comprised as follows:

- Corporate income tax 8%.
- Personal income tax 11%.
- Social security taxes 34%.
- Taxes on goods and services 28%.
- Taxes on international trade 4%.
- Other taxes 3%.
- Non-tax revenues 12%.

1. The Tax System

a) Formulation of Tax Policy

The allocation of responsibility in tax matters is determined by the Constitution and by the Public Finance Law. The Ministry of Finance has the responsibility at the national level for formulating tax policy and for drafting amendments to the tax laws. Some taxes (e.g. property taxes) are established and administered by local governments. All national tax legislation must be adopted by the Parliament. "Government Decisions" (equivalent to regulations) are issued by the government to supplement the laws, and the Ministry of Finance also publishes "Instructions", which are intended to explain and clarify the application of the legislation.

b) Budget Procedure

The Ministry of Finance prepares the budget. Annual budgets set out broad fiscal objectives and their sustainability. Fiscal projections are not reviewed by independent public institutions, and tax expenditures are not identified.

c) Administration and Control

The Audit Court of Romania is charged with fiscal control over the management and use of state financial resources. It functions independently of the government and is answerable to Parliament.

Romanian companies that meet certain criteria are subject to statutory audit and must comply with international accounting standards. The criteria are established by the Ministry of Finance and are based on turnover, assets value and number of employees (and are broadly in line with the EC directives). The audits are conducted by members of the Chamber of Auditors, which has adopted international standards and the IFAC ethics code.

Companies may be selected for further audit by the tax department. (In 2001, 197 companies were audited and the number is expected to grow.) New tax audit rules were adopted in December 1999, specifying limitation periods (five years except in the case of tax evasion) and the procedures to be followed. Penalties, of up to 50% of tax payable, are imposed for late payment and for various other offences. In 1999, an incentive for prompt payment was introduced, taxpayers being given a 5% reduction in the amount of tax payable if paid before the due date.

A 1999 FIAS study stressed the low tax collection ratio in Romania compared to other countries, and tax evasion is believed to be common.

2. *Corporate Income Tax*

The business income of companies and of partnerships are taxed under the Profits Tax legislation. Profits Tax is payable by resident legal entities (including partnerships) and by foreign legal entities with a permanent establishment in Romania.

The corporate tax system is essentially of the “classical” type, with profits being fully taxed at the corporate level and distributions being taxed in the hands of the individual shareholders, by means of a final withholding tax. Dividends paid to another resident company are tax-free in the hands of the recipient, but are subject to a 10% withholding tax collected by the paying company.

a) Taxpayers

The profits tax is imposed on the worldwide profits of all resident companies and partnerships, and on the Romanian-source profits of non-resident entities that carry on business through a permanent establishment there. A company is treated as resident in Romania if it has its legal seat there. There is no provision for group taxation.

Individuals who carry on business as sole proprietors are taxed under the individual income tax (below), but partnerships are considered to be legal entities and are taxed under the profits tax.

b) Tax Rate

Profits tax is levied at a flat rate of 25%, down from 38%, as from 1 January 2000. The rate for gambling, nightclubs, casinos, etc. is 25% on not more than 5% of income. Small and medium-sized enterprises (SMEs) are taxed at the same 25% statutory tax rate.

c) Tax Base

Taxable income is based on accounting profits, adjusted for tax purposes. Inventory may be valued using the FIFO method, the average cost method, or actual cost method.

d) Inclusions in Income

Capital gains from the disposal of the company’s fixed assets are generally treated as part of its normal business income and taxed accordingly. Special rules apply to commercial companies with state participation, and to gains and losses on foreign exchange.

e) Deductions

Companies are required to establish a legal reserve and to transfer part of their profits until the amount of the reserve equals 20% of their share capital. These transfers to the reserve are treated as a deductible expense. Special rules govern the treatment of legal reserves for banks.

As a general principle, taxpayers are allowed to deduct all expenses incurred in earning profits. However, there are a number of restrictions. The deduction for representation costs is restricted to 2% of net income, and the treatment of bad debts is somewhat complex.

f) Depreciation

Depreciation allowances may be claimed for both tangible and intangible assets. However, depreciation claims require the approval of a local tax office (except in the case of certain technical machinery and computers). Assets are normally depreciated on a straight-line basis, based on the useful life of the asset (as set out in regulations), although the taxpayer may elect to use the declining balance method except for buildings and other constructions. Once a method is chosen for a given asset, it cannot be changed.

Taxpayers may also apply to be allowed to claim accelerated depreciation, which requires the approval of the local tax office. This method allows up to 50% of cost to be deducted in the first year, with the remainder depreciated according to the straight-line method. Intangible assets, including capitalised expenses relating to the company's establishment, R&D expenses, and computer software, are written off over five years by the straight-line method.

Depreciation deductions are mandatory. Taxpayers are entitled to make annual adjustments for inflation, by revaluing assets, but only where the cumulative rate of inflation for the preceding 3 years exceeds 100%.

g) Losses

Net operating losses may be carried forward for five years, except in the case of a change of ownership of the company. No carry-back is permitted.

h) Dividends

A Romanian company paying a dividend is required to withhold tax at 10% (or, in the case of payment to a non-resident, the lower treaty rate). Dividends received from a resident company are not included in taxable profits, being subject to final withholding tax of 10% when paid. Dividends received from a non-resident company are taxable, with a credit for foreign tax paid (see below). Dividends paid to an individual resident in Romania are subject to a withholding tax of 5%, and this tax is a final tax.

i) Anti-Avoidance Provisions

Transfer pricing adjustments may be made by the tax authorities using the arm's length approach. The burden of proof is on the taxpayer.

3. *International Aspects*

a) Foreign Tax Credit

Companies and individuals resident in Romania are taxed on their worldwide income. In the absence of a tax treaty, a unilateral credit, calculated on a per-country basis, may be claimed for foreign tax paid.

b) Non-resident Withholding Tax

A 10% withholding tax is levied on dividends paid to a non-resident company. For payments to non-resident individuals, the dividend withholding tax rate is 5%. Interest paid to non-residents is taxed at 10%, although some types of interest payments are exempt. The withholding tax rate for royalties, fees for services, etc. is 15%. These rates may be reduced by treaty, where the relevant treaty withholding rates are:

- Direct dividends:
  0% in the case of some payments to the Netherlands.
  1% in the case of Kuwait.
  3% in the cases of Ireland and United Arab Emirates.
  5% in the cases of Armenia, Australia, Belgium, Croatia, Finland, Hungary, Lebanon, Luxembourg, Malta, Poland, and Yugoslavia (FR).
  7% in the case of South Korea.
  8% in the case of Georgia.
  10% in the cases of Albania, Bangladesh, Belarus, Bulgaria, China, Cyprus, the Czech Republic, Denmark, Egypt, France, Germany, Italy, Japan, Kazakhstan, North Korea, Malaysia, Moldova, Norway, Pakistan, Philippines, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Syria, Ukraine, the United Kingdom, the United States, Uzbekistan, and Zambia.

Higher rates are prescribed in the treaties with Algeria, Austria, Canada, Ecuador, Greece, India, Indonesia, Israel, Jordan, Morocco, Namibia, Nigeria, Russia, South Africa, Sri Lanka, Thailand, Turkey, and Vietnam. However, in those cases the standard non-treaty rates of 10%, or 5%, will apply.

- Portfolio dividends:
  1% in the case of Kuwait.
  3% in the cases of Ireland and United Arab Emirates.
  5% in the cases of Croatia, Finland and Lebanon.
  8% in the case of Georgia.
  10% or more in other treaties, in which case the standard non-treaty rates of 10% or 5% apply.

- Interest:
  0% in the case of the Netherlands (for some interest payments – in other cases the rate is 3%).
  1% in the case of Kuwait.
  3% in the cases of Ireland and United Arab Emirates.
  5% in the cases of Finland, Lebanon, and Malta.
  7% in the case of the Czech Republic.
  7.5% in the case of Syria.
  10% or more in other treaties, in which case the standard non-treaty rate of 10% applies.

- Royalties:
  0% in the case of Switzerland.
  0% or 3% in the cases of Ireland, the Netherlands and the United Arab Emirates.
  5% in the cases of Belgium, Cyprus, Finland, Georgia, Greece, Lebanon, and Malta.
  7% in the cases of China and South Korea.
  10% in the cases of Armenia, Austria, Bangladesh, Croatia, the Czech Republic, Denmark, Ecuador, France, Germany, Hungary, Israel, Italy, Japan, North Korea, Luxembourg, Morocco, Norway, Poland, Portugal, Russia, Spain, Sri Lanka, Sweden, Syria, Turkey, Uzbekistan, and FR Yugoslavia.
  12% in the cases of Malaysia and Tunisia (12.5% in the cases of Nigeria and Pakistan).
  15% or more in other treaties, in which case the standard non-treaty rate of 15% applies.

4. *Individual Income Tax*

The individual income tax was fundamentally revised in 1999, the new system being applicable as from 1 January 2000 and replacing the former schedular system. Resident individuals are now taxed on their global income and non-residents on their income from Romanian sources.

Individual income tax is levied at progressive rates, reaching a top marginal rate of 40% on incomes in excess of 7.95m ROL. There are intermediate rates of 18, 23, 28, and 34%. Business income of individuals is included in their taxable income, but in the case of some types of small sole-proprietorships, income is computed as a percentage of turnover. Dividends are subject to a final withholding tax of 5%, and interest to a final tax of 1%. Capital gains on the disposal of shares are subject to a 1% withholding tax (on the amount of the gain) all other capital gains are exempt.

There is no special tax regime for expatriates, but consultants (resident and non-resident) working on certain qualifying projects are exempt from tax. (Those projects typically are projects financed by international bodies.) A further exemption was recently announced for eligible information technology specialists.

The combined burden of income tax and social security contributions is high, even by the standards of the region, and the absence of any expatriate relief has led to various schemes being adopted to reduce tax. Typically, managers and other experts have been employed by affiliated non-resident companies and their services have been leased to the Romanian company in return for a service fee, which is subject only to a 15% withholding tax. This practice is apparently no longer accepted by the Romanian authorities who regard the payments as Romanian-source employment income.

5. *Social Security Contributions*

As noted above, social security contributions are unusually high. Employers make contributions at a rate of 30% on gross remuneration, and in some cases the rate is as high as 40%. However, there are also reductions (of 4% or 6%) where new jobs are created. In addition, employers must contribute to the disabled persons' fund, the health insurance fund, the national unemployment fund, and the special state education fund. Together, these contributions add up to a further 17% and in some cases more. Employees must contribute to the unemployment, pension and health funds, with the total employee rate being 13%. There is no cap on contributions and no relief for expatriates, although it seems that they can be avoided if the expatriate is employed and paid by a foreign company.

6. *Consumption Taxes*

The Romanian VAT was introduced in 1993 and has been modified a number of times since then. It underwent major changes effective 1 January 2000. The standard rate was reduced to 19% (from 22%) and the reduced rate of 11% eliminated. It now conforms fairly closely to the EC model.

The principal complaint in the past has related to the slowness of the tax authorities in making refunds (which should be made within 30 days of application) and the fact that, when refunds are eventually made, their value has been severely eroded by inflation. In part, this problem has been offset by the various exemptions from VAT on imported goods.

A new system of excise duties was introduced in 1997. Duties are imposed on the usual range of products – alcohol, tobacco and fuel oils – and on natural gas. In addition, duties between 15% and 50% are imposed on specified items, such as coffee, crystal, perfumes, audio and video equipment, and air-conditioning equipment. Motor vehicles are subject to an additional excise tax between 1% and 18%.

7. Import Duties

The present Customs Code (Law 141/1997) brought Romania's customs legislation into line with the EC rules. Imports are subject to duty according to their classification in the (Brussels) harmonised system, with rates ranging from 0% to 45%. Romania is a member of the WTO, EFTA and CEFTA, and has signed an association agreement with the EC, under which tariffs are to be reduced over a ten-year period.

8. Other Taxes

There are numerous other taxes, such as road and motor vehicle taxes, taxes on the transfer of land or buildings, and stamp duties. Property tax on land and buildings is a local tax.

C. Investment Incentives

Romania's policy with respect to tax incentives has been highly inconsistent over the past years. Incentives have been introduced, then removed when budgetary constraints demand, only to be replaced within a short time by new incentives. The multitude of overlapping incentives and the frequency with which they have been changed make it difficult, even for the Romanian tax authorities, to be sure which incentives apply at any given time for a given taxpayer situation.

The following summary reviews the principal tax incentives that were in force in 2001:

1. Expenditure-based incentives

- *Reinvestment allowance (general)* – a reinvestment allowance is provided against profits tax, earned at the rate of 50% on the portion of investment in tangible or intangible assets, financed by retained earnings. Reinvested profits must be credited to a reserve that cannot be used for payment of dividends. The allowance does not affect the depreciation basis of assets.
- *Reinvestment allowance* (SMEs) – for small and medium-sized enterprises, a reinvestment allowance is provided against Profits Tax, earned at the rate of 100% on the portion of investment in tangible or intangible assets, financed by retained earnings.[1] Reinvested profits must be credited to a reserve that cannot be used for payment of dividends. The allowance does not affect the depreciation basis of assets.
- *Reinvestment allowance (large projects)* – for new large-scale investments (exceeding US $1 million), a reinvestment allowance is provided against profits tax, earned at the rate of 20% on the portion of investment, in tangible or intangible assets, financed by retained earnings. Reinvested profits must be credited to a reserve that cannot be used for payment of dividends. The allowance does not affect the depreciation basis of assets. (Note that this tax allowance, together with the accelerated depreciation provisions also targeted at large projects (see below), means that investors can deduct 70% of the value of their investment in the first year).
- *Accelerated depreciation* – accelerated depreciation is given to new large-scale capital expenditures (exceeding $1 million), with 50% of the depreciable cost being deductible in the year of investment, with the remainder depreciated in subsequent years under the straight-line method.

2. Profit-based incentives

- *Preferential tax rate* (SMEs, *employment-based*) – the profits tax rate is reduced from 25% to 20% for profits of small and medium-sized enterprises, conditional on the enterprise increasing the number employees by 10% over the previous year.
- *Preferential tax rate (exports)* – the profits tax rate is reduced from 25% to 5% for profits derived from exports of goods produced by the taxpayer, provided the revenues are received in a foreign currency through a Romanian bank.

3. VAT *and customs duty incentives*

- VAT *and customs duties exemption* (*general*) – all investors are exempt from VAT and customs duty on the importation of capital goods contributed in kind to the share capital of a company.
- C*ustoms duties exemption* (*technology*) – all investors are exempt from customs duties on the importation of technology and equipment used for new investment over US $1 million.
- C*ustoms duties exemption* (SME*s*) – small and medium-sized enterprises are exempt from custom duties on the importation of certain raw materials, equipment and intangibles to be used in production.

4. *Zone incentives*

- I*nvestment in disadvantaged zones* – new incentives were introduced in 1998 (which have since been modified) to promote investment in designated "disadvantaged zones". Some 29 disadvantaged zones have since been designated, principally in remote areas with poor infrastructure or in areas with high unemployment.

The tax incentives in these zones include:

– T*ax holiday* – full exemption from profits tax for so long as the zone remains designated (zones are designated for a period of three to ten years).
– VAT *and customs duty exemption* – on the importation of machinery, equipment and raw materials used in production, and
– exemption from fees payable on conversion of agricultural land to other purposes.

In addition, investors are eligible to receive grants from the Special Fund for Development.

- F*ree-zones* – Six free zones exist in Romania, regulated by Law No. 84/1992 – Arad-Curtici, Braila, Constanta Sud/Basarabi, Galati, Giurgiu, and Sulina (note that Sulina had been established in 1878 and re-opened in 1978). There has been talk, over the past ten years, of establishing a joint zone with Moldova and Ukraine, in the Galati-Reni region. The zones are co-ordinated by the National Agency of Free Trade Zones, which comes under the control of the Ministry of Transportation. The zones tend to be between 100ha and 200ha in area. Activities that may be carried on include warehousing, packaging, manufacturing and processing.
- Investors in the zones enjoy a number of non-tax privileges, although these have become less important as conditions in the rest of the country have been liberalised.

The tax incentives in these zones include:

– T*ax holiday* – full exemption from profits tax.
– VAT *and customs duty exemption* – on the importation of all goods entering free zones.

- I*ndustrial parks* – a new set of incentives was introduced, by Law No. 134/2000, for investment in designated "industrial parks". Industrial parks come under the control of the National Agency for Regional Development (ANDR), which establishes the administrative rules for the parks and approves their establishment. The establishment of an industrial park may be proposed by a local government, or by a joint stock company formed for the purpose of administering a park. Thus a foreign investor could form a company to run an industrial park. In order to be approved, a minimum of five companies must undertake to do business in the park and to provide a minimum of 300 new jobs within three years. Various other formalities (environmental impact study, feasibility study, etc.) must be complied with.

The tax incentives in industrial parks include:

– T*ax holiday* – full exemption from profits tax on profits derived from export of goods or services produced or provided in a park.

- *Reinvestment allowance* – provided for five years, earned at 100% on profits reinvested in a park, and
- VAT *and customs duties exemption* – on the importation of machinery, equipment and raw materials used in production.

5. General Experience with Investment Incentives

Most tax incentives are given automatically, although the investor may be required to provide proof that the qualifying conditions are met (especially those conditions based on employment creation). Investors in disadvantaged zones require a certificate, issued by the appropriate agency for regional development, and free zone enterprises must have a certificate of registration issued by the zone administration.

The 1999 FIAS report concluded that the incentives were mostly not cost-effective, and their design was unsound, in that they did not treat investors equally, were difficult to administer, and added instability to the tax system. In that respect, the VAT incentives were especially bad, attacking the very basis of the VAT system, and being inefficient, inequitable, unworkable and "highly pernicious in their effects". The situation was greatly aggravated by the events of 1999, when most existing incentives (including some that had been in effect for as little as three months) were abrogated with no "grandfathering" provision. This provoked an outcry from investors, complaining of the broken promises and the unpredictability of the business environment. One Turkish investor instituted legal proceedings against the Romanian Government claiming damages for breach of contract (over the proposed sale of a share in an oil refinery) and alleging bad faith. To make matters worse, a new incentive, for large "qualifying investment projects" (exceeding $50 m.) was introduced only three months later. The qualifying conditions were such that only one new investment, the Renault investment in the Dacia car manufacturer, met all the conditions. The provision was subsequently repealed.

In the light of criticism received from bodies such as the IMF and the World Bank, the Romanian Government has taken some steps to reduce and to rationalise its incentives. In its Letter of Intent to the IMF, of 17 October 2001, it stated its commitment to substantially reduce the number of VAT exemptions, to eliminate the customs duty exemption for raw materials, and not to introduce tax holidays or any new discretionary incentives. Nevertheless, since the events of 1999 it has reinstated the concessions to SMEs, has introduced the industrial park regime, and has enacted a number of other more minor incentives.

D. Postscript

During 2002, a number of further changes were made to the investment incentives regime. The changes include:

- *Reinvestment allowance* – the general (50%) reinvestment allowance, the SME (100%) reinvestment allowance, and the large project (20%) reinvestment allowance were replaced, as of July 2002, with a uniform 20% investment allowance (deducted against the allowable depreciable capital base).
- *Preferential tax rate* – the preferential SME rate (20%) was eliminated as of July 2002. The preferential rate for export profits was increased from 5% to 6% in 2002, and to 12.5% for 2003 (the preferential export rate is scheduled to be eliminated as of 2004).
- VAT *and customs duty exemption* – the VAT exemption on the importation of capital goods contributed in kind to the share capital of a company was removed, replaced with a VAT deferral for the full investment period. The exemption for SMEs from VAT and customs duties on importation of raw materials to be used in production activities was removed

In addition, a new Profit Tax Law came into force in 2002. The new law proposes the elimination of a number of the existing investment incentives, including some of those applicable in the free zones and the industrial parks.[2] Incentives granted for investment in the disadvantaged zones will also be restricted.

A new VAT Law entered into force on 1 June 2002. This also removes a number of exemptions. The new regulations provides for heavy penalties when tax authorities delay the VAT refunds. In July 2002, a new Romanian Agency for Foreign Investment (ARIS) was set up.

NOTES

1. For the purpose of the incentive legislation, an SME is defined as a firm with an average number of employees less than 250 and an annual turnover less than 8 million Euro. Furthermore, qualifying SMEs must be in the manufacturing or service sector.

2. As of September 2001, the tax holiday for exports, and the reinvestment allowance for industrial parks, is replaced with *supplementary deduction of* 20% of the acquisition price of tangible assets, in addition to the allowable depreciation expense. As of July 2002, the tax holiday for free zones is replaced with a 5% CIT rate (compared with the general 25% rate), scheduled to expire in 2004. However, a 5 year tax holiday continues to apply for large investments (in excess of US $1 million) in a processing industry.

Chapter 14.

SERBIA AND MONTENEGRO

On 4 February 2003, the Yugoslavian Parliament adopted a new constitution for a state union between Serbia and Montenegro. The two semi-independent republics will share a common defence and foreign policy but will maintain separate economies, currencies and customs services. Each of the republics will in practice continue with its own economic system, with harmonisation taking place in the process of joining the European Union. After three years, both states will be free to organise referendums on independence and secede if they so choose. The Federal Republic of Yugoslavia (FRY) was comprised of two republics – the Republic of Montenegro, and the Republic of Serbia. (Since 1999, the Serbian province of Kosovo has been under UN administration.)

The government of Serbia and Montenegro has only limited jurisdiction over investment and taxation, with the republics already having extensive legislative power in those fields. Consequently, the republican laws are different in a number of respects. Nevertheless, there are sufficient similarities in the existing laws, due mainly to the common origin of many of the provisions, to make it more practical to deal with both republics together, pointing out differences where these are significant.

***Summary statistics* (2001)**

Population: 10.6 million (Republic of Montenegro: 0.6 mill.; Republic of Serbia: 10.0 mill. (8.5 mill. excluding Kosovo);
GDP: $10.9 billion (est.); GDP per capita: $1,027
Inward FDI flows: 2000: $25 million; 2001: $165 mill.; 1993 – 2001 (total): $1,359 mill.

A. Foreign Investment

1. *The Environment for* FDI

The environment for foreign investment in Serbia and Montenegro has evolved in a rather different way from that of most of its neighbours. The former Socialist Federal Republic of Yugoslavia (SFRY) was considerably more open to foreign investment than were Albania, Bulgaria and (to a lesser extent) Romania. Joint ventures with foreign participation were permitted as early as 1967. A programme of economic reforms was embarked on in 1988, notably with the adoption of the Enterprises Act and the Foreign Investment Act, under which wholly foreign-owned entities were allowed. Serbia and Montenegro also probably possessed the best infrastructure in the region.

In 1992, following the break-up of the country, the two remaining republics of Montenegro and Serbia constituted the Federal Republic of Yugoslavia. Thereafter, until the end of 2000, FR Yugoslavia was involved in almost continuous conflict. In May 1992, the UN Security Council imposed economic sanctions on Yugoslavia, which were not lifted until October 1996. Then, in 1998, with the escalating conflict in Kosovo, the U.S. and the EU imposed new sanctions, including a ban on foreign investment. Sanctions were followed with the NATO bombing campaign, during which much of the infrastructure in Serbia was destroyed. Sanctions were not lifted until October 2000, following the political changes that occurred earlier that month.

Given the circumstances, it is surprising that any foreign investments at all were made during the decade 1991-2000. Moreover, the Serbian Government actually reversed some of the economic measures that had been introduced in 1988, with some enterprises that had been privatised being taken back into state or social ownership. By contrast, the Republic of Montenegro became increasingly independent during that period, and introduced further measures to liberalise its economy and to attract investors. Its attempts largely failed due to its proximity to the conflicts.

Since taking office in January 2001, the new Serbian Government has embarked on a comprehensive programme of legislative reform. New measures planned, or already introduced, include the following:

- A comprehensive macro-economic stabilisation package that has already brought inflation down from 116% in 2000 to 40% in 2001, with an expected 20% rate in 2002.
- A fiscal reform package that will reduce the number of taxes to six (from more than 200), and make the system more "corruption-resistant".
- A price liberalisation programme that has removed almost all government controls on pricing;
- A programme of banking reforms.
- A comprehensive new privatisation law, under which privatisation is to be completed within four years.
- Comprehensive customs reform, including the negotiation of a number of free trade agreements.
- A new (federal) law on foreign investments.
- Aggressive anti-corruption efforts, including new legislation and membership of the SPAI initiative.
- Reintegration with international institutions.

2. *The Regulation of Foreign Investment*

At present, foreign investment in Serbia and Montenegro is regulated at both state union and republican levels. According to the new Constitution, the government of the state union is responsibility for foreign relations, foreign trade, defence, monetary and exchange rate policy, and customs. (In practice, Montenegro has assumed most of those responsibilities for itself: for example, while Serbia continues to use the *dinar*, Montenegro adopted the DM (and now the *Euro*) as its official currency.)

Thus, foreign investment falls within the federal responsibility, although it will no longer do so after the new "union state" comes into existence. The basic legislative framework for foreign investment in both republics is now set out in the new Foreign Investment Law of 17 January 2002, which repeals and replaces the earlier laws of 1994 and 1996. The law defines foreign investment, the types of foreign investment that are permitted, and the rights of foreign investors. Those rights, and the property rights set out in the (federal) Constitution, cannot be removed by republican legislation.

a) Restrictions on FDI

The 2002 law has further liberalised foreign investment in Serbia and Montenegro. However, it does not apply to banking, insurance, or investment in the free zones, all of which are governed by other legislation.

Foreign investors may enter into contractual or equity joint ventures with Serbian and Montenegrin enterprises, may establish wholly-owned subsidiaries, or may acquire the shares or property of an existing local enterprise under the same conditions as Serbian and Montenegrin nationals. (The earlier law applied a principle of reciprocity.) Investment is permitted without approval in all sectors of the economy, apart from arms production, although there are restrictions on investing in national parks and in some designated border areas. There are no local equity requirements for investors and 100 per cent foreign-owned enterprises are permitted. In practice, about two-thirds of foreign investments take the form of joint ventures.

Foreign investors may participate in "concessions", for the utilisation of natural resources and public property, and for the performance of public services. Additionally, concessions can be operated on a BoT basis. (A new concessions law is being prepared.)

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b) Approval and Licensing

Investment contracts (i.e. joint venture contracts or contracts to purchase shares or property) must be registered with the Federal Ministry of Trade within 30 days. In the case of a wholly-owned subsidiary, the memorandum of association must be registered. No approval as such is required, except for the restricted sectors, but the ministry determines if the contract or foundation documents are in accordance with the law and the condition of reciprocity. All contracts and foundation documents concerning foreign investments are entered in a special register.

c) Forms of Doing Business

The 1996 Enterprises Act provided for a variety of forms of doing business, including the limited-liability company, joint stock company, general partnership and limited partnership. Additional forms, not available to a foreign investor, are social enterprises, state enterprises and co-operative enterprises. In addition, business may be carried on by a sole proprietorship. A limited liability company or joint stock company can be formed with a single shareholder. Partnerships are treated as legal persons.

A foreign company may have a representative office in Serbia and Montenegro: it is required to register and is restricted in the activities that it may engage in. There is some confusion (which the new law does not seem to resolve) as to whether a branch may be established, although foreign companies are allowed to carry out temporary contractual activities (e.g. civil engineering works) without those activities being regarded as branch operations.

d) Property Rights

Both the federal and republican Constitutions guarantee the right to own property. This right applies equally to foreign investors, who may own both movable and immovable property. No person may be deprived of property except in accordance with the law. Expropriation is permitted only for a public purpose and with adequate and prompt compensation. The Foreign Investment Law provides an additional guarantee that rights acquired at the time of registration cannot be removed or diminished by subsequent legislation.

FR Yugoslavia (as well as the former SFRY) has entered into bilateral investment protection treaties with: Afghanistan, Austria, Bangladesh, Belarus, Bulgaria, Canada, China, Congo, Croatia, the Czech Republic, Egypt, France, Germany, Ghana, Greece, Guinea, Hungary, India, Indonesia, Italy, Kuwait, Libya, FYR Macedonia, Madagascar, Malaysia, the Netherlands, North Korea, Peru, Poland, Romania, Russia, Senegal, the Slovak Republic, Sudan, Sweden, Tanzania, Thailand, Turkey, Uganda, Ukraine, the United States, Zaire and Zimbabwe.

The rampant corruption that occurred under the former regime in Serbia, the confused patchwork of laws in both republics and at the federal level, and a judicial system that has been described as "overworked, unreliable and inefficient", have meant that property rights in the past have been far less well protected in practice than they appear to be on paper. Both Montenegro and Serbia, however, are now participating in the Stability Pact Anti-Corruption Initiative and have recently undertaken sweeping reforms of their legal systems.

e) Foreign Exchange

In Serbia, a new foreign exchange law is due to be adopted in 2002, which will substantially liberalise the foreign exchange market. In Montenegro, the currency is the Euro. The new Foreign Investment Law guarantees the right of investors to freely convert domestic currency into foreign convertible currency, and to repatriate profits, proceeds of sale, property or compensation received on expropriation.

f) Import and Export

In the past, FR Yugoslavia pursued a highly protectionist trade policy. A new Customs Law, adopted in 2001, has simplified the tariff structure and lowered rates. FR Yugoslavia has also entered into a number of free trade agreements with neighbouring states and further agreements are being negotiated.

g) Dispute Resolution

Under the new law, all disputes arising from investments may be resolved before the Yugoslav courts or be referred to domestic or international commercial arbitration by agreement of the parties.

3. *Privatisation*

The privatisation process began in 1989. Since 1991, Montenegro and Serbia have followed somewhat different paths. In that year, Serbia adopted more restrictive legislation and, in 1994, actually annulled some sales on the ground that they had been made at unreasonably low values. Privatisation virtually came to a standstill until the end of 1997, when a new law was adopted. It was again largely put on hold in February 2001, while new legislation was being prepared. However, it got under way again later in the year, with the assistance of a programme supported by the World Bank, and a number of larger enterprises are to be auctioned in 2002. In Montenegro, the capital of most state-owned enterprises was transferred to a number of special funds by the end of 1995. A Privatisation Council was established in 1998 and some 300 enterprises were targeted for privatisation, some by international auction and others under a voucher scheme. The programme was reported to be proceeding according to schedule at the end of 2001.

In Serbia and Montenegro as a whole, the EBRD *Transition Report* 2001 considered that small-scale privatisation was largely completed but that large-scale privatisation had barely started. Only about 40% of the Serbian and Montenegrin authority was in private hands (by mid-2001), although that figure may understate the true position because of the extent of the informal economy.

The privatisation process has been complicated in Serbia and Montenegro due to the rather unique system of enterprise ownership that existed in the former Socialist Federal Republic. Although some large enterprises were state-owned, the most common form of ownership was that described as "social ownership", which has sometimes meant, in effect, that there is no real owner at all, and no one able to take strategic decisions.

B. Taxation

The tax systems in both Montenegro and Serbia are in the process of fundamental reform. Major revisions were made to virtually all of Serbia's taxes in April 2001, and more far-reaching reforms are planned.

The overall level of taxation, and of government expenditure, is moderate by European standards. The projections for 2002 are that revenues will amount to around 45% of GDP. Tax revenues in 2000 (for Serbia) were made up as follows:

- Corporate income tax 1%.
- Personal income tax 15%.
- Social security and payroll taxes 39%.
- Taxes on goods and services 36%.
- Taxes on international trade 6%.
- Other taxes 3%.

1. *The Tax System*

Taxation is imposed at three levels of government – federal, republican and local. The federal foundations of the Tax System Act of 1996 define the different taxes that may be imposed by the republics

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and subordinate levels of government, as an attempt to secure some form of harmonisation of the republican taxes. However, both republics have in practice retained their own independent tax systems. The federal parliament can impose customs duties and stamp duties. Montenegro adopted its own Customs Law at the end of 2001 and established its own customs service, collecting customs duties for its own budget.

The principal taxing function is exercised at the republican level. That is, the republics determine, subject (at least in theory) to the Foundations of the Tax System Act, which taxes are imposed, and determine the tax rate and base. Local or provincial governments establish some taxes, such as the payroll tax, and determine the fees for various administrative services.

a) Formulation of Tax Policy

The Ministry of Finance in each republic formulates tax policy and drafts tax legislation. Tax legislation must be passed by the parliament.

b) Budget Procedure

The Serbian budget is prepared by the Ministry of Finance. The Memorandum on the Budget serves for defining the broad fiscal objectives and their sustainability. There is no formal tax expenditure budget, although the Serbian tax department has made an estimate of the budgetary cost of incentives.

c) Administration and Control

Tax policies are subject to the scrutiny of the parliament, which examines the budget and other proposed legislation. In addition, the Public Revenues Administration is required to submit an annual report to the republican government. There is at present no supreme auditing institution. Budgetary inspection is conducted within the Ministry of Finance.

The tax laws require that large and medium-sized enterprises be subject to commercial audits. Tax audits are conducted by the Public Revenues Administration. Penalties for tax evasion can amount to as much as ten times the tax evaded and companies can be suspended from carrying on business for up to 12 months.

2. *Corporate Income Tax*

A new Corporate Income Tax (CIT) Law was introduced in Serbia in April 2001. The CIT follows a partial integration (partial inclusion) model, with legal entities taxed on their profits and dividends taxed in the hands of shareholders. However, only one-half of the dividend is taxed. In the case of dividends paid from one resident company to another, double taxation in respect of withholding tax and underlying corporate income tax is relieved by means of a dividend tax credit. Dividends paid to resident individuals are subject to withholding tax that, in some cases, is a final tax (see below).

a) Taxpayers

The CIT is imposed on the worldwide profits of companies and on the profits of non-resident companies derived from business activities carried on in Serbia and Montenegro through a permanent establishment. A company is resident in Serbia and Montenegro if it is incorporated there or has its place of management and control there. A group of companies may elect for consolidation if the parent company and its subsidiaries are all resident in Serbia and Montenegro and the parent owns at least 70% of the shares of each subsidiary.

Partnerships (general or limited) are regarded as legal persons and pay CIT. Partnership income paid to a partner is subject to a 20% withholding tax. To avoid (or reduce) double taxation, only one-half of the distribution to a partner is included in income, with a credit for the withholding tax. An individual carrying

on business as a sole proprietor is taxed under the Personal Income Tax (PIT) Law. Business profits are computed based on the same rules as for companies.

b) Tax Rate

The CIT rate was lowered to 20% in 1999, having previously been 25% from 1996 and 30% before then.

c) Tax Base

Taxable income is determined by accounting profits adjusted for tax purposes. Accounting standards are governed by the (federal) Accounting Law. Inventory is valued using the average cost method. Other inventory valuation methods are not permitted.

d) Inclusions in Income

Capital gains are taxable together with other income.

e) Deductions

The general rule is that expenses properly recorded in the company's accounts are deductible, other than those items that are specifically disallowed. The latter include allocations to reserves and provisions for bad debts (which are allowed only for banks); advertising, promotion or entertainment expenses in excess of 3% of turnover; and fines and penalties.

No deduction may be claimed by a permanent establishment of a non-resident company in respect of interest or royalties charged by the head office.

f) Depreciation

Depreciation may be deducted in accordance with the accounting regulations. There are some 1120 different classes of assets. The straight-line, declining balance (applying a prescribed coefficient) or per unit methods (subject to restrictions) may be used for tangible assets. Only the straight-line method may be used for intangibles. Once a method is selected it must be used until the asset is fully depreciated. (In practice, almost all taxpayers use the straight-line method, since that was the only method permitted until recently.) Depreciation is inflation adjusted, by reference to the consumer price index, in accordance with the Accounting Law. Depreciation deductions are mandatory.

g) Losses

Losses may be carried forward for five years, even in the case of a merger.

h) Dividends

Dividends received from a resident company are included in taxable profits, with a direct credit for the withholding tax and an indirect credit for the (notional) CIT paid by the distributing company. Dividends received from a non-resident company are taxable, a foreign tax credit is allowed for any withholding tax and, in the case of direct dividends (25% ownership) an indirect credit is also allowed.

A resident company paying a dividend to a resident individual or company must withhold tax at 20%. (In the case of payments to individuals, tax is withheld on one-half of the dividend, making the effective rate 10%.) The same rate applies to dividends paid to non-residents except where a treaty prescribes a lower rate.

i) Anti-Avoidance Provisions

There is no general anti-avoidance provision, although the tax authorities are entitled to ignore "fictitious" transactions. Transfer pricing rules apply to transactions between associated persons, which must be disclosed. The primary method for determining the arm's length price is the comparable uncontrolled price method. When there are no available direct comparables, the cost-plus method is applied. There is a thin capitalisation rule prescribing a 4:1 debt/equity ratio for determining disallowed interest deductions. No controlled foreign company legislation exists.

3. *International Aspects*

a) Foreign Tax Credit

In the absence of a tax treaty, a unilateral foreign tax credit is allowed. An indirect credit is also allowed in the case of direct dividends (25% ownership).

b) Withholding Tax

A 20% withholding tax is levied on dividends, interest, royalties, rents, fees for technical services, and other income paid to non-residents. That rate may be reduced by tax treaty. The relevant treaty withholding rates are as follows:

- Direct dividends:
  0% in the case of China, Cyprus, Germany, Hungary, Italy, Malaysia, North Korea, Norway, Romania and Sri Lanka.
  5% in the cases of Belarus, Bulgaria, the Czech Republic, Denmark, Egypt, Finland, France, FYR Macedonia, the Netherlands, Poland, Russia, the Slovak Republic, Sweden, the United Kingdom, and Zimbabwe.
  10% in the case of Belgium.

- Portfolio dividends:
  0% in the case of Malaysia.
  5% in the cases of China and Romania.
  10% in the cases of Cyprus, Hungary, Italy, North Korea and Ukraine.
  12.5% in the case of Sri Lanka.
  15% in other cases.

- Interest:
  0% in the cases of the Czech Republic, Denmark, Finland, France, Germany, Hungary, Netherlands, Norway and Sweden.
  7.5% in the case of Romania.
  8% in the case of Belarus.
  10% in other cases, except Belgium and Egypt (15%).

- Royalties:
  0% in the cases of France and Sweden.
  10% in other cases, except Egypt (15%).

4. *Individual Income Tax*

The Personal Income Tax (PIT) Law was originally adopted in 1992, but has been revised on a number of occasions, most recently in 2001. Residents of Serbia and Montenegro are taxed on their total worldwide income. Non-resident individuals are taxed only on income earned in Serbia and Montenegro. The PIT is basically a schedular tax, with an additional high-income surtax.

Salaries are subject to a flat 14% withholding tax (19% in Montenegro) on gross salary. Other forms of income are taxed at a flat rate of 20%, mostly through withholding. Where an individual's total yearly income exceeds YUN 300,000 an additional surtax is imposed (on income in excess of the threshold) at progressive rates, rising from 10% to 20% on incomes in excess of YUN 600,000. The threshold is indexed and currently stands at YUN 502,050. For expatriates working in Serbia, the surtax threshold is increased to YUN 1,400,000, (now indexed to 2,342,900).

5. *Social Security Contributions*

Social security contributions are shared equally between employer and employee. The total social security contribution rate – covering pension, health and unemployment plans – amounts to 16.3% of gross salary, for both employers and employees (20% in Montenegro). Contributions are capped at five times the average salary.

6. *Consumption Taxes*

a) Value Added Tax

It is intended to introduce VAT in 2004. At present there is a single-stage retail sales tax, at a rate of 20%, on the sale of goods, and a separate 20% tax on the provision of some services.

b) Excise Taxes

There are the usual excise taxes on alcohol, mineral oils and tobacco as well as on coffee, soft drinks and some luxury items.

7. *Import Duties*

A new Customs Law is expected to be adopted in Serbia in 2002. (Montenegro adopted a new law in 2001.) The existing customs tariff is generally in line with EU standards and with the harmonised (Brussels) system. Serbia and Montenegro is not presently a member of EFTA or CEFTA, but plans to be.

8. *Other Taxes*

Property tax is levied on land and on shares. (Rates of tax are lower in Montenegro.) An urban land use charge is imposed by local authorities and there are various other local taxes.

C. Investment Incentives

The Serbian and Montenegrin system of investment incentives underwent a major revision in 2001, with many existing incentives being abolished and replaced by new measures (with existing investors retaining their privileges to abolished incentives).[1] The following summarises the principal tax incentives in force in 2001:

1. *Expenditure-based incentives*

- *Investment tax credit (general)* – a tax credit is provided as an offset from corporate income tax, earned at a 10% rate on investment in fixed assets used in a firm's regular business activity. However, the reduction in tax may not exceed 50% of the total (pre-credit) CIT liability for the year. Any unutilised portion of the credit may be carried forward for up to five years. The credit is in addition to the full depreciation deduction.
- *Investment tax credit (SMEs)* – a tax credit is provided to SMEs as an offset from corporate income tax, earned at a 30% rate on investment in fixed assets used in a firm's regular business activity. The reduction in tax may not exceed 70% of the total (pre-credit) CIT liability for the year. Any unutilised portion of

the credit may be carried forward for up to five years. The credit is in addition to the full depreciation deduction.

- *Accelerated depreciation* – taxpayers may claim accelerated depreciation (at 25% above the normal rate) for investment in computers, assets used in environmental protection or energy conservation, for science, research and personnel training and for a number of other purposes. Accelerated depreciation is optional and can be postponed to a subsequent year.

2. *Employment-based incentives*[2]

- *Employment tax credit* – an employment tax credit is provided as a set-off against corporate income tax, earned at the rate of 40% of labour costs of new employees (registered as unemployed at the time of hiring), provided that the hiring firm has not reduced the number of employees in the previous year. Labour costs include the gross wages of the new employees, plus social security contributions. (Salaries and social security contributions remain fully deductible in computing taxable profits.) The credit may be claimed for two years from the start of employment. A number of conditions are attached in order to target the incentive to new employment.[3]

3. *Profit-based incentives*

- *Tax holidays (general)* – profit on investments in activities subject to a concession contract (e.g. a contract enabling exploration or exploitation of a natural resource) is fully exempt from tax for a period of up to five years from the date the investment is completed. The actual period of exemption is determined by the concession contract (negotiated with government officials). Net operating losses from the holiday period can be carried forward to offset future income for up to five years.
- *Tax holiday (regional)* – profit on investments in underdeveloped regions is full exempt from tax for a period of two years. (The incentive applies only to existing companies that establish a new branch in the region separate records must be kept for the branch.)

4. *Customs duty incentives*

- *Customs duty exemption* – an exemption from customs duties is granted in respect of fixed assets (other than motor vehicles or gambling machines) imported by foreign investors as an in-kind contribution to share capital.

5. *Zone incentives*

a) Free trade zones

The 1994 law on Free Zones provides for the establishment of customs free zones. There are currently 13 such zones in Serbia – in Belgrade, Kovin, Lapovo, Mladenovac, Novi Sad, Pirot, Prahovo, Sabac, Senta, Smedorevo, Sombor, Sremska Mitrovica and Vladicin Han. In Montenegro, there is a free port in the city of Bar. Free trade zones are under customs control and must be securely fenced. Any activity may be carried on in a zone that may lawfully be carried on in Serbia and Montenegro. There are no foreign ownership requirements or restrictions, and no requirements that goods produced in the zones be exported. However, before a zone may be established, the relevant ministry must be satisfied that it is economically justified and should be able to export not less than 30% of its annual production. The government also has power to close a zone if, in three consecutive years, its exports are less than 50% of its total production.

The tax incentive in free trade zones is restricted to an *exemption from customs duties* for goods entering the zones (apart from a small customs clearance charge). Goods entering Serbia and Montenegro from a zone are considered to be imported and are subject to duty on their original imported value, but not on the proportion of value-added in the zone.

b) The Montenegro Offshore Regime

In 1996 the Republic of Montenegro adopted a law providing for the establishment of "offshore" companies in what is referred to as the "free trade zone of Montenegro". Only a foreign company or individual may establish an "international enterprise" in the zone, but a zone enterprise may co-operate with local businesses. All "activity related to the global economy" may be carried on in the zone: examples that are given include international trade, the provision of financial, management or consulting services, audio-visual production, development of information technology, and real estate activity. A number of offshore banks are registered in the zone.

Tax incentives provided to companies operating in the free trade zone of Montenegro, and to certain (foreign) employees of those companies, include the following:

– *Preferential tax rate* (profit-based incentive) – zone companies pay profits tax at the rate of 2.5%;
– *Customs duty exemption* – companies are exempt from customs duties on imported equipment and other items necessary for company activities;
– *Exemption from certain business-related taxes* – zone companies are exempt from sales, property, building and land taxes, and from local administrative fees and charges;
– *Preferential tax rate* – the rate of personal income tax for qualified (foreign) individuals is reduced to 5%;
– *Certain tax exemptions* – qualified (foreign) individuals are exempt from inheritance and capital gains taxes, and from customs duties on imported goods for personal use.

6. *General Experience with Investment Incentives*

Given the economic and political circumstances that prevailed in FR Yugoslavia during the 1990s, which operated as an almost complete deterrent to foreign investment, the country's experience with tax incentives is obviously very limited. Nevertheless, that experience was sufficiently negative to justify replacing the more important incentives in 2001. In particular, the authorities concluded that:

- The (previous) investment allowance for investment in fixed assets, shares and government bonds was widely abused, mostly by companies claiming the allowance for investments in the shares of their own subsidiaries.
- The (previous) tax credit based on the proportion of foreign participation was difficult to administer, because the proportion could change over time, and because it was sometimes unclear when the five-year period commenced.
- It was also difficult to determine the commencement date of the tax holiday for newly established companies.

D. Postscript

A new (federal) Law on Foreign Investments was adopted in January 2002.

In Serbia, a new Law on Budgetary Systems was adopted in February 2002, but it is not yet in force. The Serbian Government is currently engaged in a major revision of its investment incentive regime. In October 2002, it announced that it intended to reduce the standard CIT rate to 14 percent, and to introduce tax holidays of up to 10 years for some large investments.

NOTES

1. As of July 1, 2001, the following incentives were repealed: i) tax holidays, of from 1 to 5 years, for newly established companies; ii) investment allowances granted for investment in fixed assets, shares and government bonds; and iii) investment tax credits, for a 5-year period, for investments with more than 10% foreign participation, proportionate to the foreign share in total equity.

2. The employment tax credit (like provisions providing relief from customs duty and VAT) is also an expenditure-based incentive (for hiring labour, rather than capital). However, we use the term expenditure-based incentive here primarily for the purpose of grouping investment expenditure based programmes.

3. As noted in the main text, the progressive PIT surtax schedule is modified for expatriate employees. This is not an employment incentive, in the sense that it is not earned by firms as a percentage of labour costs. Instead, it is an income-based incentive, provided at the employee level (however, to the extent that high personal income tax is shifted onto employers in the form of higher gross wages, the tax relief may lower the cost of (new and existing) expatriate employees).

The Stability Pact for South Eastern Europe is a political declaration and framework agreement adopted in June 1999 to encourage and strengthen co-operation among the countries of South East Europe (SEE) and to facilitate, co-ordinate and streamline efforts to ensure stability and economic growth in the region. (see www.stabilitypact.org)

The South East Europe Compact for Reform, Investment, Integrity and Growth ("The Investment Compact") is a key component of the Stability Pact under Working Table II on Economic Reconstruction, Development and Co-operation. Private investment is essential to facilitate the transition to market economy structures and to underpin social and economic development. The Investment Compact promotes and supports policy reforms that aim to improve the investment climate in South East Europe and thereby encourage investment and the development of a strong private sector. The main objectives of the Investment Compact are to:

- Improve the climate for business and investment;
- Attract and encourage private investment;
- Ensure private sector involvement in the reform process;
- Instigate and monitor the implementation of reform.

The participating SEE countries in the Investment Compact are: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Former Yugoslav Republic of Macedonia, Romania, Serbia and Montenegro[1]. Building on the core principle of the Investment Compact that "ownership" of reform rests within the region itself, the Investment Compact seeks to share the long experience of OECD countries. It provides region-wide peer review and capacity building through dialogue on successful policy development and ensures identification of practical steps to implement reform and transition.

The work of the Investment Compact is actively supported and financed by seventeen OECD Member countries: Austria, Belgium, Czech Republic, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Norway, Sweden, Switzerland, Turkey, United Kingdom and United States.
(see www.investmentcompact.org)

NOTE

1. On 4 February 2003, the Yugoslavian Parliament adopted a new constitution for a state union called Serbia and Montenegro.

FOREWORD

This report presents findings from the Regional Flagship Initiative under the Investment Compact of the Stability Pact to assist officials in countries of South East Europe (SEE) in identifying and advancing tax policy changes to reduce impediments to foreign and domestic direct investment.[1] SEE countries participating in the project include Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the former Yugoslav Republic (FYR) of Macedonia, Moldova, Romania, and Serbia and Montenegro[2]. The report also addresses for comparative purposes selected aspects of tax systems in Croatia and Moldova (SEE countries not participating in the project), Hungary, Poland, the Czech Republic, the Slovak Republic, Slovenia, Estonia, Latvia, Lithuania, Belarus, and Ukraine.

Importantly, a number of steps have been taken and tax policy changes introduced over the course of the project, during 2001-2002, that correspond to the direction of the arguments developed in the workshops and reported here. However, further policy adjustments to reduce impediments to investment should be addressed, while ongoing pressures that would reverse positive change should be resisted. SEE country officials in tax, economic development and foreign investment review agency departments are encouraged to reflect further on this report and its main observations and policy options.

The project focuses on special tax incentives and main tax systems and features relevant to direct investment and in place in 2001/2002, with information gathered largely from detailed questionnaires issued to SEE countries in the spring of 2001 and follow-up questionnaires.[3] An initial workshop was hosted by Romania, in Bucharest on 8-9 November 2001, to review information gathered from participating SEE countries, and to begin a dialogue towards identifying areas that the project could most usefully focus on. A "technical workshop" on tax modelling was held in Vienna, 15-19 April 2002, providing participants with a review of methods and spreadsheet models to analyse tax revenue consequences of policy changes. A second policy workshop, elaborating key tax policy design issues and country experiences, was held in Vienna on 22-24 April 2002.

The policy workshops were attended by the following senior tax officials:[4] *Albania*: Mr. Artan Beka, Mr. Spartak Gjini, Ms. Silvana Meko, Mr. Kasem Seferi; *Bosnia and Herzegovina*: Mr. Goran Babic; *Bulgaria*: Mrs. Vesela Shikova, Mrs. Venetka Todorova; *Former Yugoslav Republic of Macedonia*: Ms. Svetlana Janevska, Ms. Vera Kazankova, Mr. Borce Smilevski; *Romania*: Ms. Mihaela Capota, Dr. Cornelia Petreanu, Mrs. Liliana Stoianoff; *Federal Republic of Yugoslavia*: *Serbia*: Prof. Dr. Dejan Popovic, Mr. Dusko Stojkov. The OECD wishes to underline its appreciation of the time given and efforts of these individuals and their colleagues in collaborating on this project.

The report provides a review of issues considered at the policy workshops, along with observations and main findings from the assessment of tax regimes relevant to direct investment in the participating SEE countries. The report includes an examination in Part I of linkages between host country taxation and investment, exploring key elements of and interactions between tax policy, tax administration and the "enabling environment" for FDI. Part II summaries the foreign investment environment and tax systems and tax incentives in place in SEE countries in 2001/2002, while Part III provides comparisons of tax policies and FDI performance, along with main findings and a discussion of policy options. A draft of the report was circulated to participating SEE officials in November 2002, to obtain feedback prior to the preparation of the final draft for publishing in December 2002.

The main observations and findings address a wide range of considerations relevant to the twin goals of providing a tax environment that is enabling to investment, while at the same time capable of raising a

fair share of tax on host country profits. Achieving these twin goals requires a careful balancing of considerations and a realistic assessment of results under alternative approaches. One key consideration is that the ability to use the tax system to attract investment depends critically on the state of the "enabling environment" in a host country. Special tax incentives are unlikely to attract investment where political instability, economic instability, and/or governance problems remain a serious issue. In such cases, efforts to administer a tax incentive may heighten uncertainty and perceived risks and *discourage* investment. Therefore, in addition to considering incentives targeted to specific investors or types of investment, countries are advised to consider whether broadly-based tax provisions would be a preferable option. At the same time, it is clearly important to review the operation and effects of basic features of corporate income tax and other host country taxes to ensure that they are not impeding investment, and where they are, to consider what positive changes could be introduced.

Adoption of the principles, approaches and amendments suggested in the report, in whole or in part, will require careful assessment by SEE policy-makers. Some positive policy changes have already been introduced. Further reforms will need to be considered, and the effects of these on revenues forecasted over the medium term. Flexibility will no doubt be required, and implementation dates will depend on the country's fiscal position as well as views on how business will react to tax policy changes. Clearly, obligations under EU rules (notably *Europe Agreements and Stabilisation and Association Agreements*) must also be taken into account. Certain recommendations will require additional work, as it has not been possible to elaborate all possible positive changes in this single report. It will therefore be necessary to consider implementation plans and a timetable for future work in certain identified areas.

The Co-Chairs of the Investment Compact express their thanks and appreciation to the OECD Centre for Tax Policy and Administration, and the expert contributions from OECD and SEE countries. The comprehensive descriptions and analysis provide an excellent reference for SEE country policy makers in planning future tax frameworks.

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ACRONYMS

ANDR	National Agency for Regional Development
ARIS	Romanian Agency for Foreign Investment
CEE	Central and Eastern Europe
CEFTA	Central European Free Trade Agreement
CFC	Controlled foreign company
CIT	Corporate Income tax
EBRD	European Bank for Reconstruction and Development
ECOFIN	The ECOFIN Council coordinates economic policy in the EU
EFTA	European Free Trade Association
EME	Emerging Market Economics Ltd.
EPZ	Export-processing zone
FDI	Foreign Direct Investment
FEZ	Free trade zone
FIAS	Foreign Investment Advisory Board
FIFO	First-in/ First-out (inventory method)
FIPA	Foreign investment promotion agency
FRY	Federal Republic of Yugoslavia
FYR Macedonia	The former Yugoslav Republic of Macedonia
GATT	General Agreement on Tariffs and Trade
ICSID	International Centre for the Settlement of Investment Disputes
LIBOR	London Inter-Bank Offer Rate
LIFO	Last-in/Last-out (inventory method)
MEPO	Export Promotion Organisation of Moldova
MIDA	Moldovian Investment Development Agency
MIGA	Multilateral Investment Guarantee Agency
MNE	Multinational Enterprises
NAFTA	North American Free Trade Area
NATO	North Atlantic Treaty Organisation
OLI	Ownership, location, internalisation
OpCoB	Operating Company B
PCo	Parent Company
PIT	Personal income tax
PV	Present value
RSFIL	Foreign investment law of the Republic of Srpska
SEE	South East Europe
SEZ	Special Economic Zone
SFRY	Socialist Federal Republic of Yugoslavia
SMEs	Small and medium-size enterprises
VAT	Value-added Tax
WIR	World Investment Report
WTO	World Trade Organisation

EXECUTIVE SUMMARY

This report provides a review of findings and policy options arising out of an initiative under the Investment Compact of the Stability Pact to assist tax officials in the countries of South East Europe (SEE) in identifying and advancing policy changes to reduce impediments to direct investment, both foreign and domestic. Albania, Bosnia and Herzegovina, Bulgaria, the former Yugoslav Republic of Macedonia, Romania and the Federal Republic of Yugoslavia (now: Serbia and Montenegro) participated in the project, which concentrates on tax incentives and main tax systems and features relevant to direct investment and in place in 2001/2002.

The main observations address a range of considerations relevant to the twin goals of providing a tax environment that is enabling to investment, while at the same time capable of raising a fair share of tax on host country profits. A main finding of the report is the very limited ability of tax incentives to attract additional investment in SEE countries on account of a number of factors.

First and perhaps foremost is the fact that FDI decisions in the SEE region are typically based on expectations of above-normal rates of return, but accompanied by a high perceived level of risk (including political, economic, governance and other risks). Difficulties in predicting macro-economic developments tied to political and economic instabilities in the region, difficulties in predicting the application (or not) of host country laws, and difficulties in predicting costs tied to dealings with host country bureaucracy, on top of other market-related uncertainties, imply significant project risk. These difficulties in predicting project outcomes tend to render questions over the exact level of the effective host-country tax rate as relatively unimportant, provided that the effective tax rate is not viewed as excessively high. This is particularly true where significant scope exists for multinationals to effectively set the effective host country tax burden that they are willing to bear, through the use of careful tax planning.

This view was confirmed in a survey of SEE investors by Emerging Market Economics Ltd., which found that special tax incentives, rather than encouraging FDI, either were not taken into account (were judged to be unimportant), or operated to *discourage* investment. Tax incentives were discouraging to investment where the provisions were difficult to track, understand or comply with and/or invited corrupt behaviour on the part of tax officials, tending to increase project costs and uncertainty. Particularly discouraging were non-transparent incentive regimes, including those subject to frequent change and involving excessive administrative discretion. Investors exhibited a strong preference for stable and sound tax systems that did not deviate significantly from international norms.

The following observations relevant to addressing tax impediments to FDI in SEE countries are drawn out in the report:

- Unstable and non-transparent tax policies, combined with non-transparent and corrupt administrative practices have contributed to project costs and heightened perceptions of project risk in many SEE countries, tending to discourage investment. Tax incentives have tended to contribute to uncertainty and project risk, particularly where administered in a discretionary fashion.
- The "enabling environment" should include a relatively simple tax system offering competitive host country tax treatment, with basic corporate tax rules that generally follow international practice.
- Statutory Corporate Income Tax (CIT) rates currently in force in the SEE countries, in the range of 15% to 25%, are already moderate or low by international standards. Efforts to improve competitiveness of tax systems should concentrate on removing impediments, streamlining and relaxing certain basic

features of tax systems, improving transparency and predictability, while imposing a reasonable tax burden on host country profits. Such changes should operate to lower project costs, lessen the scope for corruption, reduce actual and perceived levels of risk, which taken together should operate to encourage additional greenfield FDI.

- Countries relying on book income, as a basis for measuring taxable income, should aim to ensure that national standards for proper, transparent financial accounting are established, understood and followed by taxpayers and adhered to by public (auditing) officials.
- Progressive and regressive corporate tax rate structures should be reconsidered, given the benefits of a flat (single) corporate tax rate structure.
- The classical tax variant with final withholding tax on dividends paid to resident shareholders, which most SEE countries have opted for, offers a number of advantages, including simplicity, relative ease of administration, and reduced scope for evasion. SEE countries relying on alternative mechanisms to integrate corporate and shareholder-level taxation should reconsider the benefits of this approach.
- Double or possibly multiple taxation of profit distributed along a chain of related corporations should be avoided, for example by providing dividend exemptions on inter-corporate dividends between related companies, with final withholding on dividends paid outside a corporate group. Dividend gross-up and credit provisions at the corporate shareholder level should be avoided if found to add to complexity.

A substantial portion of the report focuses on targeted corporate tax incentives, which have been widely used by SEE countries to promote investment (as elaborated below). A key finding of the project is the coexistence in SEE countries of generous and largely inefficient tax incentive provisions alongside core corporate income tax provisions that, in certain areas, are at odds with international norms.

- Business loss carry-forward provisions have been found to be restrictive in certain SEE countries (e.g. three-year loss carry-forward), relative to international norms (five-to-seven year or more). Where tax is a factor in business location choice, restrictive loss carry-forward provisions could be a discouraging factor. Countries with restrictive loss carry-forward rules are therefore encouraged to relax those rules as quickly as possible.
- Depreciation rules, another key component of corporate income tax systems, are found in a number of SEE countries to be overly complex and/or restrictive in the amount of tax relief provided. Certain changes (e.g. greater use of the declining-balance method, a reduction in the number of depreciable asset classes) would streamline tax calculations while providing considerable scope for encouraging investment, while limiting revenue losses. Where depreciation claims continue to be mandatory (i.e. unclaimed capital costs cannot be carried over), greater importance should be placed on relaxing loss carryover provisions (as noted above).

The report also touches on a number of observations relating to international aspects of corporate tax systems, and to the operation of other domestic taxes. Certain policies are recommended (e.g. introduction or strengthening of base protection measures) without elaborating possible approaches and variants which are beyond the scope of the current project which has focused on “domestic” tax provisions:

- Where tax treaties do not currently exist with major capital exporting nations, and the conclusion of such treaties is expected to be a number of years off, countries should consider reducing statutory (non-treaty) rates to levels closer to treaty norms.
- Countries without thin-capitalisation rules, or with variants that have been found to be weak, should consider introducing or strengthening those rules.
- Countries without transfer pricing rules should consider their introduction, while those with such rules are encouraged to examine their application in practice to ensure enforcement of arm’s length prices in international transactions.
- Countries with relatively high employer social security contribution rates should consider lowering those rates to international norms as quickly as possible. Where such reductions are not possible currently due to budgetary pressures, labour market conditions should be examined to determine if institutional changes are possible to enable a partial shifting of such contributions onto employees.

- Where special customs duty exemptions are provided on imports of machinery and equipment for certain investors, consideration should be given to a general reduction or elimination of import duties on most types of machinery and equipment. Where revenue requirements make immediate implementation impossible, consideration might be given to an announced gradual reduction.

As noted above, the report devotes considerable attention to the use of tax incentives. A critical finding is the continued existence in many SEE countries of profit-based incentives, including tax holidays and partial profit exemptions, which are particularly prone to aggressive tax planning. The review and analysis of incentive regimes underscores the need of policy-makers to recognise the various avenues by which domestic and foreign investors can artificially characterise non-qualifying profits as profits qualifying for tax relief. Revenue losses to unintended investments obviously erode the ability of a given incentive to meet a cost-benefit test.

These concerns are compounded by the fact that protecting the host country tax base from aggressive tax-planning opportunities created by certain tax incentives requires *effective* defensive tax measures and tax administration to counter the "stripping" of host country profits to offshore financing subsidiaries. Unfortunately, SEE countries generally do not have such measures and practices, owing to the relatively limited experience of SEE tax officials in the international tax area.

The following observations are made regarding the use tax incentives in SEE countries:

- Tax holidays are an especially inefficient form of tax incentive, being the most open to tax planning. Unlike incentives earned as a percentage of investment (which cap revenue losses to some fraction of qualifying expenditures), tax holiday relief is not limited in this way to the desired activity. Instead, all returns over the holiday period on investment – including returns covering initial investment costs as well as normal and "super-normal" profits – are earned tax-free. Providing this level of tax relief on targeted profits – as well as on profits of related non-qualifying firms, transferred to tax holiday firms using non-arm's length pricing and financing arrangements – should be seen as excessive. Also, contrary to certain views, tax holidays offer limited "simplification" opportunities (e.g. where taxpayers must maintain taxpayer accounts to support tax calculations over the post-holiday period).
- For similar reasons, partial profit exemptions are viewed as an inefficient form of incentive, as they provide tax-planning opportunities and tax relief not tied to investment (albeit possibly on a reduced scale, proportionate to the percentage relief offered). Like tax holidays, partial profit exemptions are unlikely to create an efficient result, with opportunities for tax planning and corresponding revenue losses outstripping any benefits.
- Reinvestment allowances, providing a tax deduction equal to some percentage of (pre-tax) reinvested profit, are of questionable use. If incentives tied directly to investment are desired, it would seem preferable to rely on provisions that provide relief in respect of investment expenditures without regard to the specific sources of finance.
- Accelerated depreciation may be an attractive option, but likely of limited interest to investors if the basic capital cost allowance system is restrictive (e.g. mandatory depreciation claims combined with limited loss carry-forward rules). However, general accelerated depreciation applied to a streamlined system of capital cost allowance categories, when combined with five to seven year loss carry-forward rules, offers a relatively simple and efficient means to encourage investment (as elaborated in the preceding section).

While the report does not unconditionally promote the use of accelerated depreciation, it recognises the calls on policy-makers to respond to political pressures to introduce incentives to promote FDI. Given this, the report finds relative advantages with this form of tax incentive. Some support is also found for investment tax credits (largely to the limits such incentives place on revenue losses, compared to profit-based incentives). However, such incentives, while offering certain advantages, raise some concerns in the SEE context:

- Investment tax credits and investment tax allowances provide a relatively flexible mechanism for targeting additional tax relief (beyond that provided through depreciation) to qualifying investment expenditures.

Unlike tax holidays, they provide a means to curb tax revenue loss by limiting the amount of relief earned to some fraction of qualifying investment; by possibly limiting the amount of credit to some fraction of (pre-credit) tax payable (or limiting the amount of allowance to some fraction of (pre-allowance) taxable income). However, such measures may be abused by taxpayers (e.g. "churning" of qualifying assets to enable multiple access to tax relief), require separate special accounts to track unclaimed balances, and may distort investor choice towards short-lived assets.

Certain other observations are made as regards tax incentive use, including problems with multiple "stacking" of incentives, scope for zones to exacerbate rather than control rent seeking, and the need for "automatic" triggering mechanisms and a "workable" set of rules for investors and tax administrators:

- Countries should avoid excessive "stacking" of corporate tax and other incentives. Offering multiple incentives tends to be counterproductive, as it increases complexity contributing to compliance and administrative costs. It also leads to unintended patterns of tax relief across different taxpayers and asset types, leading to inefficiencies in resource allocation. Furthermore, it can create an impression to investors that the country does not have basic "enabling conditions" necessary for profit-making in the host country, and is attempting to rely on an "easy fix". In can also cast doubt over the fiscal position of the country, and contribute to concerns over sovereign risk.
- Special "zones" giving relief from profit-based taxes tend to attract highly mobile labour-intensive activities (as opposed to long-term capital intensive activities). Incremental investment will be low where zones largely cause capital to be diverted from elsewhere in the country. Where rights to operate from a special zone are granted by officials on a discretionary basis, they invite rent-seeking behaviour and weaken efforts aimed at routing corruption.
- The triggering mechanism for tax incentive relief (whatever its form) should be as "automatic" as possible, with qualifying criteria stipulated clearly in accessible laws and regulations, in an effort to minimise the scope for corruption and rent seeking (which tends to escalate with the degree of discretion given to tax officials in granting relief).
- When considering alternative incentive mechanisms, a fundamentally important requirement is a "workable" set of rules and regulations that are understandable to not just taxpayers, but also tax administrators. Tax incentive design should avoid overly complicated provisions to the extent that the tax administration is inexperienced, or otherwise weak.

The focus of the report on both corporate tax incentives and main tax design features recognises that investment "incentives" may, in effect, be realised by addressing impediments in the basic tax system, (i.e. simplifying tax calculations and lowering tax rates on business where possible, taking into account overall fiscal requirements and the incidence of alternative tax bases). Examples could include the use of a single (rather than multiple) corporate tax rate structure; streamlining complex capital cost allowance systems; liberalising restrictive loss carry-forward rules; increased reliance on (withholding) taxation at source; lowering employer social security contribution rates (offset possibly by increased Value-Added Tax (VAT) or Personal Income Tax (PIT) rates).

Lastly, the report raises a number of targeting issues that arise with incentives which, by definition, provide targeted rather than generally available tax relief. A number of general observations are drawn:

- Targeting incentives specifically to foreign investors creates distortions to the extent that foreign investors favour certain sectors or business activities over others. Such targeting is also open to tax planning (with domestic companies disguising themselves as foreign by investing through offshore holding companies), and can foster taxpayer resentment of foreign capital and apathy towards the tax system (discouraging voluntary compliance and feeding the underground economy). Targeting foreign investors may also run counter to national treatment obligations (e.g. WTO and/or EU law).
- Targeting incentives to new investment projects attempts to limit tax relief to new capital. However, qualifying new investment may not be incremental (i.e. would occur in the absence of tax relief). Windfall losses are also imposed on existing capital (reduced share values), raising equity concerns. Tax planning is also encouraged, with investors characterising "old" (existing) capital as "new" (e.g. through

selling a company to an offshore holding company, which then reinvests the funds into the host country).

- Targeting by size of investment creates distortions over the choice of firm size and the organisation of business activities, resulting in inefficiencies. An exception may be drawn if market failure is resulting in an under-investment in small firms. However, it is important that one assess whether small firms are being denied capital for reasons of market failure, or as a result of the normal and proper functioning of credit and equity markets. If instances of true market failure tend to be the exception rather than the rule, such targeting should be discouraged, given the inability of government to properly target incentives. Where small firms are targeted, rules should be introduced to discourage large firms from dividing assets across new companies so as to qualify for relief.
- Targeting by business activity, in general, should be discouraged, in particular where it is unclear that government has better information than the private sector in determining which activities/sectors are likely to be more profitable (picking "winners"). Exceptions may apply where market failure can be identified, for example in the case of R&D and environmental protection, where the private sector tends to ignore social "spillover" benefits and under-invests. However, even in these areas, it remains necessary to administer certain "grey" areas (e.g. subsidising pure research versus other forms of research versus development). Difficulties in assessing the degree of market failure suggest that incentive relief should be moderate.
- Targeting incentives to underdeveloped regions may be called for to address market failures curbing investment. However, regional-based incentives have rarely been efficient in encouraging FDI. Where programmes have failed, it is normally because of a lack of "enabling conditions", and an inability of incentives to create a critical mass of activity that would help generate these conditions. Where regional incentives are used to promote activity, despite efficiency concerns, the incentives should be carefully targeted to investment in well-specified areas, and monitored on a frequent basis to assess results. Sunset provisions in general should apply (see below), and the continuation of incentives should depend on results.
- Targeting by type of finance (e.g. retained earnings) creates distortions in capital markets and should be avoided. If the objective is to encourage investment, it would be more efficient to target investment expenditures directly (without regard to how they are financed). If the tax system is creating distortions towards excessive levels of debt finance, consideration should be given to introducing/strengthening thin-capitalisation rules.
- Targeting incentives to apply for a fixed period to temporarily boost economic growth runs a risk of mistiming (aggravating rather attenuating cycle effects). However, announcing and immediately implementing targeted incentives to apply for a short period (e.g. one to two years) may shift forward investment that would have otherwise been delayed. Furthermore, in general all incentives should be introduced with a sunset clause stipulating that a given incentive will expire at a certain date (which may then be extended, conditional on a positive evaluation of past effects).
- For SEE countries working towards membership of the EU, in the longer term their tax incentives will have to be consistent with the State Aid rules and, consequently, it seems advisable to avoid incentives of such a duration or type that they will have to be dismantled on eventual accession.
- Whatever the form of targeting, the benefits in terms of avoiding tax relief to unintended recipients must be weighed against the additional administrative costs in monitoring the programme, defending boundaries under pressure, and implementing measures to address tax abuse.
- Finally, excessive discretion in the targeting of incentives, by contributing to a lack of transparency, invites corruption and increases perceived risks, thereby discouraging investment across all (targeted and non-targeted) activities. Thus, as with the provision of incentives themselves, the process of identifying qualifying activities should be as "automatic" as possible, through careful drafting of the applicable tax laws and regulations.

On balance, the report finds merit in policy change in the direction of a relatively simple tax system offering a competitive statutory corporate income tax rate, accelerated depreciation with flexible loss carry-forward rules, and possibly carefully targeted investment tax credits (or allowances) with anti-abuse rules. At the same time, SEE countries are encouraged to implement base protection rules (e.g. transfer pricing rules, thin-capitalisation rules) to guard against aggressive tax planning and enable collection of a fair and

reasonable share of tax on host country profits that can be easily managed by MNEs. A number of tax policy changes recently introduced by SEE countries are identified that correspond to the direction of the arguments elaborated in the report.

Given that a simple corporate tax system can deliver a low effective host country tax burden – while avoiding compliance and administration costs associated with complex and possibly redundant incentive provisions – the report encourages SEE countries to resist the use or introduction of "add-on" fiscal incentives to enrich the tax pot, given their poor track-record in encouraging incremental FDI. This view recognises that the ability to use the tax system to attract investment depends critically on the state of the "enabling environment" in a host country. Special tax incentives are unlikely to attract investment where political instability, economic instability, and/or governance problems remain a serious issue. In such cases, efforts to administer a tax incentive may heighten uncertainty and perceived risks and *discourage* investment. The report closes by acknowledging the pressure on SEE countries to offer a list of special incentives given the fierce competition for FDI and the availability of a wide range of tax incentives in competing jurisdictions. However, SEE countries are advised to seriously reflect on the merits of adhering to a structurally sound system capable of generating tax revenues to help finance public expenditures (e.g. infrastructure development in support of an "enabling environment"), taking into account country experiences and the various considerations raised in the report.

This report is an output of one of the regional flagship initiatives of the Investment Compact for South East Europe, a key component of Working Table II of the Stability Pact. The Investment Compact Project is co-chaired by Austria and the OECD (see www.investmentcompact.org). This report was co-authored by W. Steven Clark, Head of the Tax Policy and Statistics Unit at the OECD Centre for Tax Policy and Administration, and Professor Alex Easson, at Queen's University, Canada, in co-operation with the Investment Compact team. The authors wish to thank Laura Power and Jody Kaylor for their contributions at the outset of the project.

The opinions expressed in this report are those of the authors and do not necessarily reflect the views of the SEE institutions participating in the survey or of the OECD and its member countries.

NOTES

1. This initiative is one of a number of "regional flagship" initiatives under the South East Europe Compact for Reform, Investment, Integrity and Growth ("Investment Compact"), a component of the Stability Pact for South East Europe.

2. On 4 February 2003, the Yugoslavian Parliament adopted a new constitution for a state union between Serbia and Montenegro. The name of the state union is Serbia and Montenegro. After three years, both states are allowed to unilaterally leave the union on public referendum. On 27 April 1992, Serbia and Montenegro had formed the "Federal Republic of Yugoslavia" as a successor state to the Socialist Federal Republic of Yugoslavia.

3. While efforts have been made to ensure that the 2001 tax system descriptions are accurate for all of the countries considered, the authors cannot ensure full accuracy of descriptions due to some difficulties encountered in the information/data collection exercise.

4. Due to conflicting schedules, Bosnia and Herzegovina, and Serbia were not represented at the first policy workshop. Also, due to conflicting schedules, certain officials who attended the first workshop were unable to attend the second workshop.

PART I.

POLICY INCENTIVES AND IMPEDIMENTS A REVIEW OF ISSUES

Part I consists of six chapters examining linkages between host country taxation and investment, explaining key elements of and interactions between tax policy, tax administration, and the "enabling environment" for direct investment in SEE countries.

Chapter 1 sets out some background for the discussion by examining the dramatic growth of FDI over the past decade, the competition among nations to attract FDI, and the degrees of success in countries in South East Europe (SEE) in attracting a share of FDI. It also briefly reviews evidence on the various factors that influence FDI decisions, and in particular the role of taxation and the importance of risk considerations in the decision-making process. In addressing the role of taxation, Chapter 1 draws on findings of a recent survey of investors in countries in South East Europe, and examines the extent to which tax factors into the investment decision-making process. The survey results stress the importance of addressing fundamentals, and illustrate how tax considerations, including tax incentives on offer, may add to project costs and heighten perceived risks, discouraging rather than encouraging investment. The lesson from this research, which supports other similar findings, is that tax incentives cannot be expected to compensate for impediments to FDI and may contribute to them.

Chapter 2 reviews some of the main tax incentives in use, and offers observations on a number of design considerations. The discussion of incentives is placed in a wider context that addresses the interaction of certain tax incentives with other main features of corporate tax systems, including depreciation rules and loss carry-over treatment. This context is important. A main finding of the report is the coexistence of rich but largely inefficient targeted tax incentives in certain systems, alongside basic tax provisions that are found to be discouraging to investment, providing less tax relief than that considered to be the (expected) international norm.

Given the need to raise tax revenues to finance public expenditures aimed at strengthening the enabling environment (e.g. infrastructure development), countries often target tax assistance to certain taxpayer groups or activities to reduce revenue losses. Aside from instances of market failure, a central question is whether tax relief should be targeted or generally available, perhaps at a reduced rate. The evidence suggests that targeting is difficult to administer and quite open to abuse, not only by taxpayers but also by tax administrators. Chapters 3 and 4 review the evidence and practice. Chapter 3 examines a popular form of targeting in the SEE region, namely that tied to duty-free zones and special economic zones. Chapter 4 examines other forms of targeting and attempts to weigh the evidence.

The last two chapters examine tax incentives in practice. Chapter 5 looks at some of the administrative issues involved in granting targeted incentives, in monitoring compliance with the conditions under which they are granted, and in countering abuse and tax avoidance. Chapter 6 revisits some of the pros and cons with the use of tax incentives, looking beyond the important issues addressed in Chapter 5. It reviews evidence on the seemingly unabated appetite for tax incentive use around the world, indicating the ever-increasing pressures to compete for FDI. Chapter 6 also examines certain constraints over the use of tax incentives, including the possible (future) application of State Aid rules, relevant to a number of SEE countries.

Chapter 1.

COMPETITION FOR FDI AND THE ROLE OF TAXATION

This chapter considers global competition for foreign direct investment (FDI), annual FDI flows to countries in Central and Eastern Europe, and in particular countries of South East Europe (SEE). It also considers the role of taxation, and tax-based incentives aimed at attracting investment ("tax incentives") in FDI decision-making. The main findings of a recent survey of direct investors in the SEE region are presented, to help place the discussion of taxation and tax incentives in a broader context that addresses a range of possible impediments to FDI, including those found in the tax system.

A. The Growing Importance of Foreign Direct Investment

1. FDI Defined

Foreign direct investment (FDI) may be defined as

"...investment made to acquire a lasting interest in an enterprise operating in an economic environment other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise." [1]

FDI occurs in a number of ways. The purchase of assets in another country, the transfer of assets to another country, reinvesting profits earned in another country – all are methods of direct investment. In the case of purchases of shares, direct investment (in contrast to portfolio investment) involves the acquisition of a substantial shareholding, such as to give control or the ability to participate in the management of the company whose shares are acquired: usually, a threshold figure of 10 per cent is taken to distinguish direct from portfolio investment. A loan to a subsidiary or affiliate is normally regarded as direct investment, whereas a loan to, or the purchase of bonds of, an unrelated company is considered to be portfolio investment.

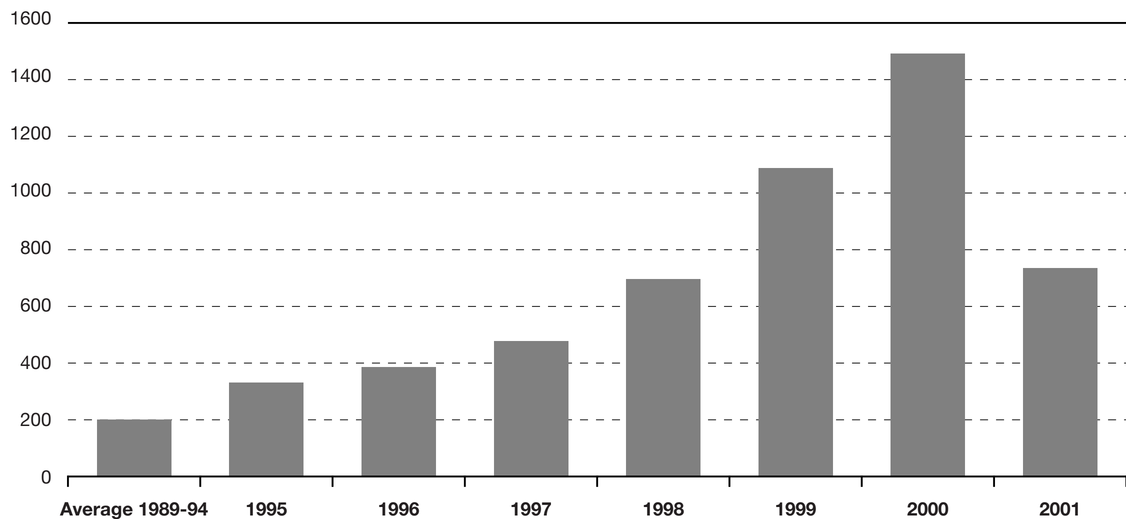
FDI takes a number of forms. The most common are:

- Acquisition of, or merger with, an existing (private or public) enterprise in another country.
- Creation of a joint venture with an existing enterprise in another country.
- Creation of a new enterprise ("greenfield" investment) in another country, and
- Additional investment or reinvestment in an existing foreign-invested project.

2. Global FDI Flows

Global FDI flows reached an all-time high of $1.5 trillion in the year 2000 – an increase of 37 per cent over the previous year – declining to $735 billion in 2001. (UNCTAD estimated global FDI inflows to have declined by 27 % in 2002).[2] FDI flows (taking the 2000 figures) have increased by more than 250 per cent since 1996, by over 500 per cent since 1990, and by more than 2000 per cent since 1982. The total global stock of FDI now stands at almost ten times greater than it was 20 years ago. Worldwide, FDI now accounts for about 14 per cent of all private capital formation, and 22 per cent of all investment in manufacturing. (For developing countries the corresponding figures are 18 and 37 per cent.) Some 63,000 multinational enterprises, with their 800,000 foreign affiliates, now account for about two-thirds of all world trade.

Chart 1-1. **Global FDI Flows 1989-2001 ($ billion)**

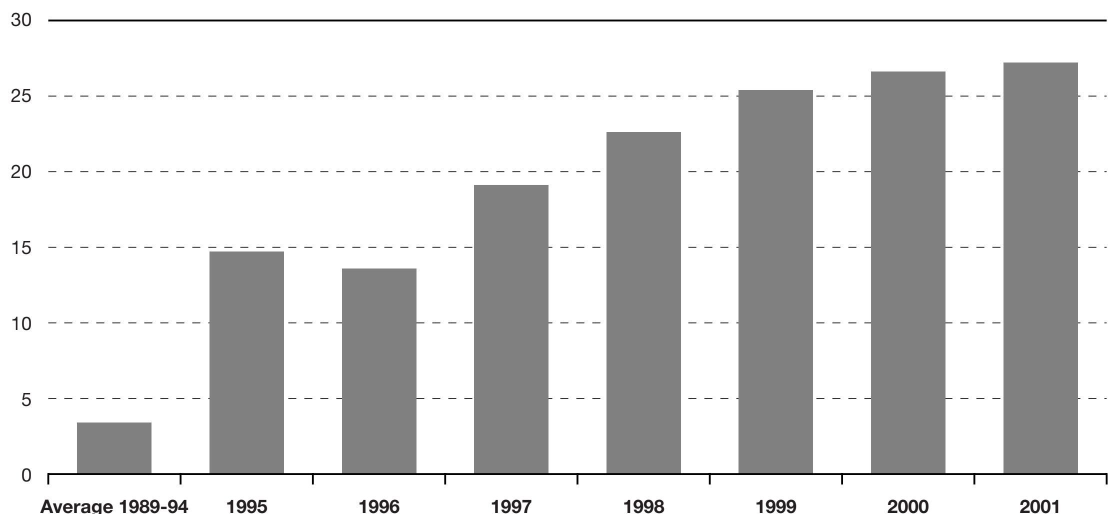


Source: UNCTAD, 2002.

3. FDI Flows to Central and Eastern Europe

FDI flows to the "transition" economies of Central and Eastern Europe (CEE)[3] have risen even more dramatically over the past decade. The region's share of the global total has increased from 0.2 per cent in 1988-90, to 2.3 per cent in 1998-2000. This percentage share is roughly equal to the region's percentage contribution to the world's total GDP, of about 2.5 per cent. Total inward FDI for the region amounted to $26.5 billion in 2000, an increase of roughly 5 per cent over the preceding year, close to double the amount received in 1996, and nearly 90 times the figure for 1990. FDI flows to CEE countries increased further to $27.2 billion in 2001, a year in which global FDI flows declined by half. The bulk of the total (over 75%) has gone to four countries – the Czech Republic, Hungary, Poland and the Russian Federation.

Chart 1-2. **FDI flows to Central and Eastern Europe, 1989-2001 ($ billion)**

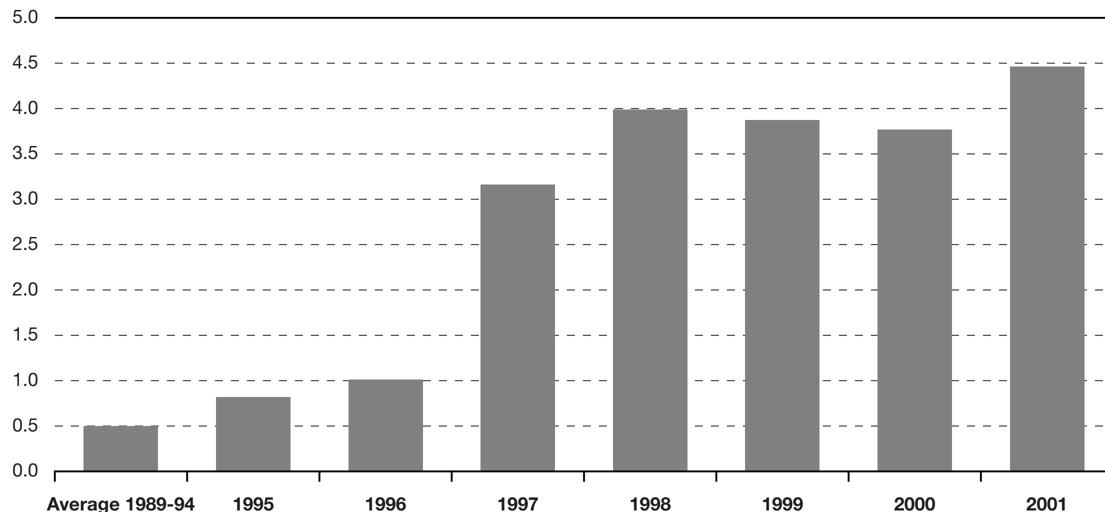


Source: UNCTAD, 2002.

4. FDI Flows to South East Europe

FDI flows to the SEE Member countries of the Stability Pact for South Eastern Europe (SEE)[4] also rose substantially over the last decade, with the year 2001 volume reaching almost 50 times that for 1991. However, after a sharp initial rise, the annual inflow remained largely static over the period 1998-2000, at just under $4 billion a year, although rising to $4.5 billion in 2001. Romania, by far the largest country in the region, accounts for more than one-quarter of the total, with Bulgaria and Croatia the other principal recipients.

Chart 1-3. **FDI Flows to SEE countries, 1989-2001 ($ billion)**



Source: UNCTAD, 2002.

B. Host Country Attitudes and Policies Toward FDI

What accounts for this remarkable worldwide increase in FDI? There would seem to have been two main driving forces – the growing profit-driven incentive of large corporations to expand their operations (and not merely their sales) beyond their own national boundaries, and an almost universal acceptance on the part of governments that FDI is essentially beneficial.

Until the middle or late 1970s many countries, including most developing countries, were uncertain of the impact of foreign investment, and often concerned about implications for national sovereignty. That attitude changed – in some countries sooner than others – and almost all countries now vie with each other to attract and retain investment. The change of attitude has been especially marked in the so-called "transition" economies. From 1979 in China, and from around 1988 in the former socialist countries of Central and Eastern Europe and the former Soviet Union, the doors have been opened wide to foreign investment. Even countries such as Cuba, North Korea and Vietnam, which still adhere to their own forms of socialism, now seek to attract FDI and have established special economic zones for foreign investors.

How has this radical change of attitude come about? In some countries the explanation obviously lies in the changes to the political and economic systems that have occurred during the past two decades. Many countries have abandoned socialism in its various forms and have embraced a market economy. One consequence of this has been the wave of mass privatisation programmes in the countries of Central and Eastern Europe and in Latin America. In many of the countries where this has occurred, privatisation has been dependent upon funds from abroad. In countries such as Argentina and Brazil, and in most of the transition economies, a substantial proportion of FDI inflows has resulted directly from privatisations.

But the trend towards the freer flow of investment capital had begun well before the collapse of the communist world. Some countries were perhaps influenced by the apparent success of the dynamic economies of southeast and eastern Asia. The rapid economic growth in those countries has been attributed to several factors, especially a high level of investment (domestic as well as foreign), the promotion of exports, and the adoption of modern technologies. The promotion of FDI was seen as a means of securing those benefits. Although the Asian economic crisis of 1997 raised concerns that large-scale foreign investment may have negative impacts, the consensus seems to be that vulnerabilities are mostly associated with portfolio investment, which is often short-term and is easily withdrawn, rather than with FDI which, by its nature, is largely intended to be long-term and cannot so readily be liquidated.

To some extent the liberalisation of FDI flows has also been brought about by the need for countries to adhere to the rules of international bodies to which they choose to belong. A relatively high degree of liberalisation is required among members of regional associations such as the European Union (EU) and the North American Free Trade Area (NAFTA); membership of the Organisation for Economic Co-operation and Development (OECD) requires the removal of most restrictions on outward capital movements; the rules of the World Trade Organisation (WTO) require the elimination of certain trade-related investment measures and the WTO's financial services agreement, reached in 1997, also has substantial FDI implications.

But for the most part the liberalisation of FDI has occurred independently and has been undertaken by countries unilaterally, or between countries pursuant to bilateral investment protection treaties. According to one study, only five out of a total of 373 FDI regulatory changes during 1991-94 were not in the direction of greater liberalisation.[5] That trend has continued: in 2000, of 150 regulatory changes affecting FDI, 147 were more favourable to investors.[6] The end result has been a pervasive competition among nations to attract FDI.

Why are countries so overwhelmingly disposed to favour (inward) FDI? What are the benefits they perceive as being derived from foreign investment in their countries? As a general proposition, it is widely believed that FDI provides the host country with:

- Increased employment.
- An increased pool of capital available for investment.
- The introduction of new skills and technology.
- Increased revenue for the host government and community, and
- Other spillover effects.[7]

Nevertheless, despite these perceived benefits, many countries still retain restrictions on FDI. Few countries now fear that they may become dominated – economically and politically – by MNEs based abroad. But there are genuine concerns that the advantages enjoyed by MNEs may enable them to eliminate domestic competition at least in certain sectors, or prevent domestic enterprises from entering those sectors. Consequently it is not unusual for foreign investors to be excluded from certain activities (e.g. financial services or retailing) or restricted to minority participation in others (e.g. exploitation of natural resources). There is also a perception that not all FDI is equally beneficial: it is the quality of the investment that matters more than the sheer quantity.

C. The Determinants of FDI

Why do firms choose to invest abroad? And what causes them to invest in one country rather than in another? A voluminous literature exists on the subject of FDI determinants. This literature is comprehensively summarised elsewhere[8] and will not be reviewed here, except in so far as it relates to the relative importance of taxation in FDI decision-making.

Much of the recent literature builds upon the theory of the "OLI triad" – ownership, location, internalisation – as the variables that govern FDI decisions.[9] Although the three are interdependent, the ownership and internalisation factors are essentially firm-specific. Typically, MNEs consider investing abroad where they

are able to exploit a *comparative advantage* that they enjoy over competitor firms in a given product market, for example by virtue of their ownership of intellectual property (i.e. know-how) and/or established position in other markets. These advantages can give rise to economies of scale and possibly significant profit, derived in part from investments (e.g. R&D) and other sunk costs incurred in the home country of the parent and/or host countries of foreign subsidiaries.

MNEs may choose to invest abroad where there is a preference to internalise or control select stages of production and/or marketing in the value-added chain of one or multiple products (as opposed to outsourcing these functions to unrelated firms).[10] These considerations are internal to the firm, in the sense that they depend on the overall activities and business strategies of the firm.

The location variable in the OLI triad determines where the firm chooses to invest, for example to maximise economies of scale or to internalise activities. The location decision focuses on the suitability of alternative sites, and is therefore influenced by external factors, for example market size.

Whatever the precise motivation or combination of motivating factors, the principal objective of FDI under the OLI triad view is to gain cost-efficient access to product markets (rather than exporting to those markets), often through exploiting comparative advantage, and/or to gain more cost-efficient access to resource (input) markets (e.g. natural resources, labour resources).

1. *Market-oriented* Investment

Market-oriented investment is driven by an expectation of earning required (normal) or superior (super-normal) returns by locating production in a given product market, as compared to the alternative of producing in the home country or elsewhere (a third country) and exporting the goods or services to the output market. Locating production in a given market rather than exporting to it may be advantageous where the product is costly to transport, owing to its size, weight or fragility. It may also be advantageous where the market is protected by tariffs or other barriers to trade which add to export costs. Finally, establishing a presence in the market, hiring local workers and possibly raising the firm's profile in other ways may increase demand for the firm's products, implying advantages operating through revenues and not just costs.

According to many surveys of investor behaviour, market access is the motivation for the majority of FDI. A survey of MNE managers conducted in 1996 found that market access rated a higher priority than access to resources (almost twice as much weight was attached to production for local markets than to labour-cost driven relocation.)[11] A 1994 survey of investors in Central and Eastern Europe found that securing access to output markets and other market-related factors were the prime reasons explaining 80 per cent of investments.[12]

It should be emphasised that size alone is not sufficient to make a market attractive as a place for productive investment – witness the difficulties of India and Russia in attracting substantial levels of investment. Consumer wealth is obviously important in determining product demand. Also critical are a range of factors that determine whether a given location is suitable ("enabling") or not, including perhaps most importantly political and economic stability. Also important are the legal, physical and business infrastructure, the cost of factors of production (e.g. skilled labour, energy), absence of bureaucratic obstruction, as well as other considerations. (Note that factor costs may not be a critical factor in deciding whether to invest in or export to a given market, particularly if the per unit costs are roughly the same for domestic competitors and other MNEs in the market).

2. *Export-oriented* Investment

Where the key motive for investment is to obtain cost-efficient access to factors of production (e.g. natural or human resources), considerations may be substantially different. In particular, market size of a given potential host country may be irrelevant – for example where the intention is to export natural resources

to the home country or to third countries, or to generate products/services using those factors in the host country to be exported abroad.

Export-oriented investment may be very mobile and short-term. The ties to a given host country would be particularly weak where the factors of production can be found in many alternative sites, and the costs in relocating investment are not large (relative to additional after-tax profits derived from relocation). Export-oriented investment may be insulated from the rest of the host country, being located in special export-processing zones. Consequently, economic and political stability may be a somewhat less important concern than in the case of market-oriented investment. The factors of crucial importance are the availability and cost of the resources that are to be utilised (labour, raw materials, energy, land).

3. Free Trade Areas and Common Markets

The basic distinction between market-oriented and resource-oriented (export-oriented) FDI has been recognised for many years. However, the existence of free trade areas or common markets, such as the EU and NAFTA, has changed the picture substantially. Where goods and services are allowed to move relatively unrestricted within a single multinational market, it is possible for FDI to be both market-oriented and resource-oriented. A single location may be selected within that market to supply all of the countries comprising the market. The market potential of the actual country where production is located becomes relatively unimportant, as is evident from the popularity of Belgium and Ireland as locations for FDI within the EU. Cost of production becomes more important than for purely market-oriented investments, as do other factors such as central location, communications and culture.

4. Other Factors and Considerations for Policy-Makers

What determines in which country or countries an MNE chooses to invest? That is of course the key question for policy-makers in countries that wish to attract FDI. Potential hosts have little or no influence on *why* a particular foreign firm chooses to invest abroad, but depending in large part on past, current and future public policy and administration, they may have a major influence on *where* it chooses to invest. In some cases, the choice of location may be an obvious one – for example where a country represents an important market and, due to trade barriers, investing in rather than exporting to that market is more profitable. Or the host country may offer abundant and cheap resources and significant profits on exports.

But more often a market-oriented or export-oriented potential investor will face a choice of several possible host countries, for example, a short list of five or six countries which might be suitable locations for their investment:[13] The precise choice of location will then depend upon a variety of different factors. Some of those factors will usually be important to all types of investment. They include:

- Political and economic stability.
- Adequate legal, physical and business infrastructure.[14]
- Secure property rights and ability to repatriate profits freely.
- Absence of bureaucratic obstacles.
- Appropriately skilled labour force.
- Adequate communications.

The relative importance of these factors, however, tends to vary according to the type of investment. For example, the relative importance to location decisions may differ according to whether the investment is market-oriented or export-oriented.[15] For a market-based investment aimed at realising scale economies, the cost of certain factors of production (e.g. skilled labour) in a given host country may be less important than for an export-oriented investment (to the extent that certain important costs have already been incurred in the development of a product).

The degree of physical presence required may also shape the relevance of various factors. Where an investment is highly capital-intensive (e.g. automobile manufacturing) and costs incurred in locating and

relocating production are significant, investors would tend to have great interest in political and economic conditions and their long-term impact in a given host country, and on plans for infrastructure development. In contrast, investors in highly mobile sector would tend to be more concerned with the current state of "enabling conditions" and their immediate implications.

The relative importance of various factors will also depend on the profit margins that investors can anticipate. Clearly, if expected risk-adjusted rates of return in locating in a given country are well above those in alternative locations for the same investment (or in other investments), then certain factors bearing on project cost would tend to take on less importance. Conversely, if profit margins are rather thin, then cost considerations across jurisdictions would tend to be more important.

The importance of various factors in FDI decision-making also depends on the stage of the decision-making process. This fact was emphasised in a recent report prepared by Emerging Market Economic (EME) Ltd., analysing the process by which MNEs identify countries for investment, with a focus on investments in South East Europe. In particular, the study explains that various detailed cost considerations (including tax incentives) tend not to be factored in until an examination of short-listed countries is undertaken.

As noted above, for market-oriented investors ("strategic" investors, in the EME report), investment decisions are often made in the context of wider business considerations such as: securing a presence in important potential or emerging markets; maximising competitive advantages of scale or cost of production; or how the investment location fits with the wider global business strategy. As a result, for the strategic investor, the investment decision may be driven by profit considerations that are not captured or relate solely by the (immediate) returns to that particular investment. For example, the investor may wish to obtain economies of scale in production, drawing in inputs (materials, physical and intangible capital produced elsewhere) and producing output to serve local markets. The critical decision is *where* to invest.

Based on its past experience and interviews with strategic investors in the SEE region, EME Ltd. identified the following sequencing of decisions in deciding upon a given investment location. The process of selection typically starts with choosing a "long list" of candidate countries based on *macro-level* criteria.[16] Relevant factors include a) economic systems and policies, and the potential for economic opportunity; b) political system and policies influencing undiversifiable sovereign risk; c) the legal and regulatory system and state of public governance; and d) assessment of the social/cultural context (social attitudes, population characteristics). These factors help determine the extent to which an "enabling environment" exists for foreign investment.

Having developed a long list, shortlisting may take account of *meso-level* criteria – essentially transaction costs determined largely by the state of development of the various forms of infrastructure and business networks.[17] The final set of factors to be considered would be *micro-level* and/or project-specific.[18] The focus at this point would be on deriving risk-adjusted expected rates of return on the project, in alternative sites. Large MNEs tend to undertake detailed scenario planning to model the probability and impact of project risks, discounting scenario-weighted projections of after-tax cash flows by discount rate reflecting sovereign risk. At the final stage of detailed analysis of the short-listed countries, risk considerations are revisited. Tax regimes are also considered in detail, either in the cash-flow exercise, or as a separate tax-planning exercise. Tax considerations may be subject to uncertainty, and factored into risk assessment.

5. The Importance of Risk Assessment

The investor survey confirmed that, as in other emerging markets, investments in SEE countries are typically made with the expectation of significant profit, but accompanied by a relatively high perceived level of uncertainty (risk). High levels of risk increase the downside volatility of estimated returns, tending to discourage investment.

Investors incorporate a variety of risk factors into their discount rate and cash flows. Sovereign risk associated with a candidate host country is typically factored into the discount rate (used to measure the present value

of expected returns). The sovereign risk element is commonly measured as the premium charged for the host country's sovereign debt (i.e. the rate of interest in excess of LIBOR (London Inter-Bank Offer Rate), which is added to the firm's internal discount rate reflecting its cost of capital. In essence, the premium to the discount rate is expected to cover the risk of the country defaulting on its foreign debt, an event that would make it difficult for the investor to repatriate dividends and/or capital.

In comparing alternative locations, cash flows may be adjusted for the probability and likely impacts of other risks (e.g. political, governance, reputation and other project risks)[19] rather than incorporating these in the discount rate. Large MNEs use detailed scenario-planning to model the probability and impact of project risks on future revenues and costs. The resulting adjusted cash flow projections are weighted (weights reflecting probability of alternative scenarios) and then discounted.[20]

The importance of risk assessment and how it affects investment decisions is of vital importance to understanding investor behaviour in the emerging market context. Based on this understanding, it becomes clear that governments able to provide investment conditions that lower sovereign and project risk would, holding other factors constant, help to increase the attractiveness of opportunities to investors.

D. Taxation as a Determinant of FDI

To what extent does taxation have an impact upon FDI decisions? This question has been the subject of many studies over the past 30 years, and answers provided and opinions on the subject continue to differ widely.[21] Some studies have considered the effects of tax systems generally, some have examined specific taxes (especially the corporate income tax), while others have concentrated on tax incentives.

In principle, taxation ought to be important, since it influences after-tax profitability. Investors that are able to achieve reduced tax exposure in one project would be expected to choose it over an identical project that has the same level of risk and return. This much seems self-evident. However, econometric studies, which seek to establish the relationship (if any) between tax burdens and FDI levels in a particular country, have been mostly inconclusive, largely due to difficulties in modelling and measuring variables thought to influence FDI flows, and in measuring consistent FDI series over time and across countries. Survey studies, based upon questionnaires addressed to MNE managers, tend to show taxation as ranking relatively low to other factors, while in some cases taxation is singled out as an important consideration (depending largely on how and to whom questions are posed).

It is evident that certain tax considerations are more likely than others to affect FDI decisions. The overall level of taxation in a country, as measured, for example, by its tax-to-GDP ratio, does not appear to directly influence inward or outward FDI. (An exception to this is where mismanaged fiscal policy threatens a country's ability to cover interest costs on its sovereign debt, leading to investor perceptions of difficulties in repatriating capital.) For example, France and Italy have relatively similar overall levels of taxation, yet attract vastly different amounts of FDI. Among OECD member states, Japan has a relatively low level of taxation and receives very little FDI, whilst Belgium and Sweden are comparatively high-tax countries yet have substantial FDI inflows. This suggests that, to the extent that tax is relevant, it is the tax mix and design features that are more important, possibly to a varying extent depending on the type of investment in question. Tax administration (and transparency) would also be expected to be important.

1. *Types of taxes*

Not surprisingly, corporate income tax (CIT) has received the greatest attention from analysts, since it most closely affects the amount of profit of a MNE that is available for distribution to shareholders. Several recent studies have found a significant relationship between effective host country CIT rates and levels of FDI.[22] A survey conducted for the Ruding Committee, for example, found that 57 per cent of MNE managers within the EU *always* regarded the (statutory) corporate tax rate on business profits to be a relevant consideration in deciding in which country to locate business activity.[23]

However, as noted above, a number of difficult modelling and data measurement problems continue to pose challenges to researchers (while survey findings raise difficulties of their own). A key problem in estimating the sensitivity of FDI to host country taxation stems from difficulties in measuring host country tax burdens. A host country average effective tax rate is measured, in principle, by dividing host country CIT revenues (plus possibly other host country taxes) by true host country profit measured on an arm's length basis. But true host country profits are difficult (if not impossible) to measure given the existence of tax-motivated profit stripping to low-tax jurisdictions (in principle, profits booked in low-tax jurisdictions should be taken into account). But this requires (confidential) firm-level data on cross-border transactions, as well as estimates of the tax-motivated elements of inter-affiliate cross-border payments.

Individual income tax and employee and employer social security contributions are generally less important considerations, except where they have an unusually large impact on labour costs. Consumption taxes, such as the value-added tax, would also typically have relatively little relevance to market-oriented FDI decisions. Such taxes tend to be passed on to consumers rather than borne by producing enterprises, and apply equally to competing domestic products and to imports.[24]

By contrast, import taxes and customs duties may be quite important in two ways. High import taxes and duties constitute a tariff wall, which may encourage MNEs to invest in a country rather than export to it. Once they are there, such duties provide protection against imports from competitors: in that way high import duties may actually constitute an incentive to some types of market-oriented investment. But at the same time, high duties and taxes on the import of machinery and other capital goods increase the initial cost of investment and the cost of imported goods used in production, and may constitute a substantial disincentive to FDI.[25]

2. *Types of Investment*

It is widely held that export-oriented FDI is more sensitive to the host country tax burden than is market-oriented investment.[26] Taxes that directly affect the cost of production and corporate income tax are typically reflected in the price of exported products or services, tending to make demand for those products (and therefore investor interest in a given export site) sensitive to host country tax considerations. Tax considerations seem to be of the greatest importance to firms exporting services,[27] followed by those manufacturing for export, and seem to be less important to firms in the natural resource sector. These differences reflect the relative mobility of the investment and the range of choice of possible locations.

By contrast, market-oriented FDI tends to be relatively little affected by considerations of taxation unless the host country tax is unusually burdensome – that is, unless the tax system (policies and/or administration) imposes compliance and possibly other costs that cannot be shifted onto others. Taxes that affect the cost of production, to the extent that they are borne by domestic and other MNE competitors and can be passed on to consumers, may not be problematic (depending on the degree of competition in output and factor markets), while taxes on profits may, to some extent, be passed to consumers. Finally, MNEs with global operations (or more limited operations but with finance affiliates located in tax havens) may have considerable scope to "manage" (reduce or largely eliminate) host country tax burdens, implying that statutory provisions may have little bearing on actual tax burdens and investment decisions.

3. *Tax Treaties and Administration*

Apart from tax rates and tax base considerations, two other tax-related factors are likely to be taken into consideration. First, MNEs will prefer to invest in countries that have concluded tax treaties with their home country in order to avoid potential double taxation, though the existence of a treaty may not be a decisive factor, particularly if an investor can invest through a third country that has a treaty with both the home and target (host) country (i.e. opportunities exist for "treaty shopping"). Second, the quality of the potential host country's tax administration is often a major consideration. Uncertainty, ambiguity, too frequent changes in the legislation, inconsistency in its interpretation and application, corrupt officials, excessive penalties and related administrative factors can constitute a severe disincentive to investment.[28]

A further factor, and one that is often overlooked, is that a large proportion of FDI is in the form of reinvestment, or of additions to existing investments. Taxation may not have played a major part in the initial decision to invest in a particular country but it may have an important influence on decisions to re-invest or to expand. Among the reasons commonly given for dissatisfaction with host country conditions are inconsistent tax laws and erratic tax administrations. This "never again" factor inevitably has a substantial effect on future investment plans.

4. *The growing importance of taxation as a factor in FDI decisions*

Most of the studies undertaken before 1990 found that taxation was a relatively minor consideration in most FDI decisions. More recent studies have tended to suggest otherwise: taxation is becoming an increasingly important factor.[29] For this development, there may be a number of explanations:

- As other barriers to FDI are eliminated, the remaining obstacles assume an increased importance. Taxation has always been recognised as being a factor in FDI decisions, other considerations being equal. Today, many of those other considerations have become more or less equal.
- The process of globalisation is characterised by greatly increased international production: the components that go to make a finished automobile may come from five or six different countries. Sales are no longer made principally in the country of production and investment is no longer oriented to a single market.
- The creation of common markets, customs unions and free trade areas has had a similar effect, making it easier to supply a number of national markets from a single location unimpeded by tariff barriers, and also sometimes reducing other differences between the Member countries. Thus, the distinction between market-oriented and export-oriented investment has become less clear.

These latter two points seem especially important. The fact that export-oriented investment is more likely than market-oriented investment to be influenced by tax considerations has been recognised for many years. However, the growth of international production and the coming into existence of free trade areas or common markets has changed the picture radically. When goods and services are allowed to move freely within a single multinational market, it is possible for FDI to be both market-oriented and export-oriented. A single location may be selected within that market to supply all of the countries comprising the market. The market potential of the actual country where production is located becomes relatively unimportant, the cost of production becomes more important, as do other factors such as central location, communications, availability of labour – and taxation.

5. *Tax considerations in SEE countries*

As a broad generalisation, the evidence regarding the possible influence of taxation on FDI decisions suggests that the setting of host country effective tax rate:

- Plays little or no part in the initial decision of MNEs to invest abroad.
- May play a more important role (although very rarely a key role) in location decisions.
- May be more important to export-oriented (than market-oriented) investment, and
- Is growing in importance.

However, interviews with SEE investors find very limited evidence of host country taxation being a relevant factor in attracting investment, given the considerable uncertainties and risks posed by investing in the region. Strategic (market-oriented) investors sometimes identified and considered taxation within the country screening process, but normally tax was not a critical issue when compared with other determining factors. Where tax was identified as important, the relevant concerns were transparency and complexity, rather than particular (e.g. tax relieving) provisions.

A common theme in investor surveys undertaken in transition economies is frustration over unstable and non-transparent elements of the tax system, in areas of both policy and administration, which are

discouraging – and therefore impeding – to investment. The results from the EME Ltd. survey of SEE investors were no exception, with the views underlying the important inter-action between transparency and certainty (or lack of it), and perceptions of project risk.

In the context of investments with high expected rates of return, but accompanied by high levels of perceived risk, investors are discouraged when they must contend with tax systems that are non-transparent due to provisions that are overly complex or at odds with international practice. Other factors contributing to uncertainty are unstable laws and regulations and unpredictable administrative practice. In such a context, incentives cannot be expected to compensate for these deficiencies that add to project risk and discourage investment. Indeed, tax incentive practices may contribute to or be a central element of these factors.[30]

This widely held perception cautions against the use of special tax incentives, with a focus instead on providing a low, competitive effective host country tax burden by careful and clever design of the basic tax provisions. SEE countries that wish to be "long-listed" as a possible investment location should recognise that MNEs generally do not even consider special tax incentives at this stage of an investment decision. Significant costs in gathering and weighing detailed information on tax and other policies simply make it too expensive to undertake this level of analysis for a candidate list of countries – particularly when the need exists to identify and model the probability and impacts of a number of critical project risks. Where tax is taken into account, the focus tends to be on main elements, including the basic corporate income tax rate, the treatment of losses, and the existence of a tax treaty network. Therefore, for countries wishing to make it onto a candidate list of countries, the focus of efforts on attracting FDI should be non-tax policy areas impacting the enabling environment, and as regards taxation, main tax considerations. Indeed, the country work has found that, where enabling conditions are relatively weak, tax incentives may make the situation even worse – and tending to add to investor uncertainty and perceptions of risk, and thus tending to decrease chances of being chosen as a suitable investment location.

NOTES

1. UNCTC (1992).
2. UNCTAD (2002), press release TAD/INF/PR/63.
3. Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, former Yugoslav Republic of Macedonia, Moldova, Poland, Romania, Russian Federation, Slovakia, Slovenia, Ukraine, Serbia and Montenegro.
4. The member countries are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, former Yugoslav Republic of Macedonia, Moldova (since 2001), Romania, and Serbia and Montenegro.
5. UNCTAD (1995) at p.3
6. UNCTAD (2001) at p.6
7. See, for example, Dunning (1994); OECD (1998).
8. See, for example, OECD (1994), Morisset and Pirnia.
9. See Dunning (1998).
10. This preference may be profit-driven, capitalising on comparative advantage, and/or based on security and confidentiality considerations.
11. UNCTAD (1997).

12. OECD (1994).

13. In doing so, it seems that most companies consider a relatively small range of potential investment locations. Many countries "are not even on their map" – World Bank (1998) at p.49.

14. Legal infrastructure covers, among other factors, systems providing law and order, enforceable contracts, dispute resolution mechanisms etc. Business infrastructure covers, among other considerations, concerns over functioning financial markets.

15. The reduction and eventual elimination of trade barriers (e.g. within free-trade areas) for certain products and services tend to reduce the distinction between market-based and export-based investment. Reductions in trade barriers lower the cost differential between tapping a market in a given country by investing in that country, versus exporting to it. Advantages in investing versus exporting may remain, however, even where trade restrictions are eliminated (implying that market size will remain an important, if less important, attribute, at least for certain products/services), due to other cost/benefit considerations.

16. In particular, the relevant macro-level criteria could include: a) economic systems/policies shaping the macro environment and the potential for economic opportunity — budget deficits, inflation, interest rates, BOP, foreign exchange reserves, extent of deregulation, tax mix, basic corporate tax rate (broad tax considerations); b) political system and policies influencing undiversifiable sovereign risk — maturity of democratic system, stability of government infrastructure, changes in government, continuity of economic policies (economic policy stability); c) legal and regulatory system, and state of public governance — business legislation {companies acts, contract law, bankruptcy laws, property rights, foreign ownership restrictions}; market regulation {competition policies, consumer protection policies, commercial policies, labour laws, environmental protection laws, accounting standards}; rule and administration of law {independence of judiciary, enforcement of judgements, access of courts and tribunals, level of corruption, regulatory burden}; d) assessment of the social/cultural context — social attitudes {cultural distance, support for foreign investment, extent of private enterprise in economy}; and population characteristics {population/general size of market, purchasing power, cultural diversity, illiteracy rate, urbanisation). These macro considerations, together with the meso factors, determine the extent to which an enabling environment exists for foreign investment.

17. For example: a) physical infrastructure (transport and communication facilities, commercial space, energy supplies); b) social infrastructure (health services, education services, civic facilities, access to amenities, living conditions); c) business infrastructure (trade facilitation, vocational training, R&D, customs and excise structure (broad tax considerations); d) business organisations (chamber of commerce, trade associations, informal networks, lobbying power of industry/sector). High-quality meso factors generally lower project costs. Low-level meso factors generally imply higher project costs (higher transportation costs, transaction costs, (compensating) wage costs).

18. The main micro-level considerations (relating to costs of factors of production and other factors bearing on net profits) generally can be categorised as follows: a) land (cost of land, rental costs, distance to markets); b) labour (availability of required skill sets, worker efficiency, minimum wage rates, days lost through industrial action); c) capital (availability of domestic credit, level of initial investment required, availability of special tax incentives); d) business specific (estimated time to payback, management liability, experience of local partners, acquisition costs); e) sector specific (attractiveness of market, level of competition).

19. Political risk covers instability of policies resulting from instability of government. Governance risk covers risks resulting from a lack of transparency in applications of laws, regulations, and from restricted access to rule of law. Reputation risk covers risk arising from a company's social and environmental impact that may be damaging to society and in turn damage its corporate reputation, impacting on sales.

20. Less sophisticated corporate investors may use simpler techniques such as payback periods, accounting for risk by setting shorter periods the greater the risk.

21. See, especially: UNCTC (1992) at pp.42-43, 48-50. For a more recent study, summarising earlier material, see OECD (2001a), Chap.4.

22. For example: Gropp and Kostial, Grubert and Mutti, Wunder. See also OECD (2001a).

23. EC Commission (1992), at p.115. The proportion rises to 80% when MNEs who *usually* take statutory CIT rates into account are included. Next in importance after CIT rates were withholding tax rates (40%), depreciation rules (36%) and loss relief (35%). The survey, however, was not concerned with other types of tax. See also Devereux.

24. See however the recent study by Desai and Hines, concluding that consumption taxes are a significant consideration. Note that consumption taxes, if sufficiently high, may lower domestic consumption demand but would not be expected to have any significant influence over export-oriented investment.

25. Halvorsen, in a study of FDI in Thailand, found customs duties and import taxes to be an important factor.

26. See, for example, Mintz and Tsiopoulos; Trela and Whalley.

27. According to the Ruding Committee report (supra, n. 25), financial service centres are the most sensitive to taxation; coordination centres and R&D centres somewhat less so. The survey conducted for the Committee found that tax was always or usually a major factor in the location of 70 percent of coordination centres and of almost 80 percent of financial centres.

28. This especially seems to be the case in some of the countries of eastern Europe (see Cannon) and Southeast Europe (see report by EME.Ltd).

29. See, for example, Wilson; Clark.

30. Poorly designed and administered tax incentives may impede investment by imposing additional project costs and uncertainties (risks), and by contributing to sovereign risk (i.e. where revenue losses contribute to a serious deterioration in the country's fiscal position).

Chapter 2.

TAX INCENTIVES AND TAX DESIGN CONSIDERATIONS

A. Introduction: Incentives for FDI

The focus of this chapter is on the use of incentives to attract direct investment. At the same time, but largely within the incentive context, a number of considerations are raised relating to basic corporate tax design. The focus on incentives is narrowed in three ways: the focus is on *fiscal* (i.e. tax) incentives, on *targeted* incentives rather than generally applicable provisions, and on *direct* investment (and often *foreign direct investment*) rather than investment generally.

The analysis stresses the importance of considering tax incentives and potential effects alongside basic features of the tax system. First, interactions of tax incentives with basic features often determine in large part the value of incentives. Second, basic features often have a greater bearing of the final tax burden, and are typically the main focus of attention of investors when addressing tax considerations.

1. *Fiscal Measures*

Investment incentives take a variety of forms but are usually classified as financial or fiscal. There are also measures of a non-monetary nature that may be listed as incentives in promotional literature of foreign investment agencies. These are often referred to as “rule-based” incentives (as opposed to monetary incentives), and include such measures as the relaxation, for qualifying investors, of the normal residence permit or work permit rules, of restrictions on capital transfers, or even of minimum pay and worker protection legislation.

Monetary incentives may be “direct” (financial) or “indirect” (fiscal). Financial incentives usually take the form of grants, preferential loans or loan guarantees on preferred terms, to assist in the acquisition of capital assets. Alternatively, the host government may agree to partly cover costs involved in establishing the operation – for example, providing infrastructure, constructing buildings or training workers. Fiscal incentives, as the term implies, operate through the tax system and confer benefits in the form of reductions in tax that would otherwise be payable.

Developed countries tend to rely on a mix of financial incentives and tax incentives. By contrast, developing countries are more likely to offer tax incentives, largely because, unlike cash grants or loans, in principle they impose little or no immediate cost. Where large investments are involved, a comprehensive “package” of financial and tax incentives may be negotiated.

Much of the literature on the subject of investment incentives expresses a preference for direct (financial) grants, as opposed to tax exemptions or reductions, principally on grounds of greater transparency. Also, there is the fact that the cost of grants is (or should be) established immediately, whereas the cost of tax incentives is often difficult to estimate. Such a preference should be conditional. Financial incentives are by no means always transparent. For example, infrastructure development is often undertaken by a host country government primarily for the benefit of specific investors, but is not always classified as an aid or grant. Also, some forms of tax incentive (e.g. exemptions from property tax) are as readily quantifiable as grants and may be just as transparent. Some also argue that the true cost of tax incentives may be lower

than that of "equivalent" financial incentives since most tax incentives benefit only those investors that eventually make a profit and are not "wasted" on unsuccessful investments.

Where tax incentives are used, it is important that the rules and take-up be transparent, with published estimates of their revenue cost, released, for example, with some form of tax expenditure budget.

2. Incentives

It is useful to distinguish between targeted (or special) incentives and generally applicable provisions of tax systems. Targeted incentives can be thought of in statutory or effective terms:

"A tax incentive can be defined either in statutory or effective terms. In statutory terms, it would be a special tax provision granted to qualified investment projects (however determined) that represents a statutorily favourable deviation from a corresponding provision applicable to investment projects in general (i.e. projects that receive no special tax provision). An implication of this definition is that any tax provision that is applicable to all investment projects does not constitute a tax incentive. … In effective terms, a tax incentive would be a special tax provision granted to qualified investment projects that has the effect of lowering the effective tax burden – measured in some way – on those projects, relative to the effective tax burden that would be borne by investors in the absence of the special tax provision." [1]

A distinguishing feature of targeted incentives is that they are not general in their application. Thus, for example, a system of accelerated depreciation offered to all investors and all investment categories would not be considered a targeted incentive, in the sense used here, even though it might benefit some investment projects (e.g. capital-intensive) more than others. (A similar distinction can be made for "rule-based" provisions: a "one-stop" investment service available to all investors is not an "incentive", though frequently described as such, whereas a residence-permit exemption for expatriate workers in hi-tech sectors is.)[2]

From the point of view of the investor, it may not matter whether a tax provision is a special incentive or a part of the general tax system. But there are instances in which the distinction may be important. For example, within the European Union, many types of tax incentives are prohibited (or require prior approval from the Commission) under the provisions regulating "state aid". The essence of a state aid is that it "....distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods...." (art.87(1)/EC). A distinction therefore is drawn between provisions that are "specific" (i.e. targeted incentives) and those that are part of the "general" system.

The most commonly employed tax incentives are:

- Full or partial exemption from profits tax (including tax holidays).
- Reduced corporate income tax rate on targeted profits.
- Investment tax allowance (or reinvestment allowance for reinvested profits).
- Accelerated depreciation of capital costs.
- Investment tax credits.
- Reduced import taxes and duties.
- Exemption from/reduction of VAT (or other forms of sales tax).
- Reduced rates of withholding tax on remittances to the home country.
- Personal income tax, social security contribution, property tax reductions for expatriates.
- Special "zone" incentives combining one or more of the above.

3. Foreign Direct Investment

The other limitation on this study is that it is restricted to *direct* investment, with special attention given to foreign direct investment. This requires a distinction to be drawn between direct investment and "portfolio" investment. As noted, the latter generally takes the form of the acquisition of securities such as shares or bonds, and is essentially "passive" in the sense that it normally does not involve any

element of control or participation in the management of the assets that form the subject of the investment. Direct investment, by contrast, is essentially active and related to the carrying on of business.

Although a country's general tax system may be conducive, or pose an impediment, to both direct and to portfolio investment, special incentives (in the sense described above) are rarely provided for portfolio investment. And although most tax incentives for direct investment tend today to be available also to domestic investors, the intended target is often foreign capital.

B. Forms of Tax Incentive

Tax incentives for FDI, taking a variety of forms (see above), operate to encourage direct investment in one of two ways: a) by reducing the after-tax cost of acquiring capital or other factors of production (e.g. labour, materials, energy), either on an immediate basis ("up-front" incentives) or on a present-value basis; or b) by reducing the effective tax rate on profits from investment ("downstream" incentives).[3] Both categories aim to increase the after-tax rate of return on and thereby encourage investment.

1. *Reduced CIT Rates*

Reduced rates of corporate income tax or profits tax may be granted to particular types of activity on a permanent or temporary basis.[4] Complete exemption from profits tax may be found in tax havens, and in the case of tax holidays, considered below. Aside from tax holidays, an exemption is usually restricted to enterprises engaged in conducting "offshore" activities, such as international finance centres, co-ordination centres and operational headquarters companies. More often, profits from such activities are taxed at very low rates – as, for example, is the case in Barbados, Cyprus, Ireland, Mauritius and Singapore.

Some countries provide or have provided a reduced rate of corporate income tax (CIT) for certain types of investment. The Irish reduced rate of 10% on manufacturing profits, in place to 2002, is an example.[5] The reduced manufacturing and profits tax rate in Canada is another.[6] Both Ireland and Canada are phasing these measures out. In some countries, reduced rates are given for investment in particular locations or regions: for example, the standard Chinese CIT rate of 30% is reduced to 15%, or 24%, in special economic zones and other designated regions.

In administering a reduced corporate tax rate, the main difficulties are clearly defining and administering what profits qualify for the lower rate, obviously critical where an enterprise has income of more than one type or from more than one source, only part of which qualifies for the reduction. Without clear definition and enforcement, taxpayers will be more successful in their attempts to have profits taxed at the low rate, derived from activities that were not the intended target under the policy. More generally, taxpayers with multiple lines of business will attempt to book costs (e.g. interest expense) into profits subject to the higher rate, and allocate revenues to profit measures subject to the lower rate.

2. *Tax Holidays*

Tax holidays are the most common form of tax incentive for investment in developing countries. A tax holiday provides a complete (or partial) exemption from profits tax (and sometimes relief from other taxes as well), with the relief being granted for a fixed number of years. In general, there are three main factors to be considered in designing tax holidays:

- The duration of the holiday.
- The date of commencement, and
- The relationship of the holiday rules to those of the normal tax system, in particular the rules on depreciation and loss carry-forward.

a) Duration

Tax holidays can vary in duration from as little as one year to as long as 20 years. For example:

- In Georgia, all new companies receive a tax holiday of one year from the date of registration, with a 50% profit exemption for a further two years.
- In China, the standard tax holiday for foreign investors is for a period of two years, to be followed by a 50% profit exemption for a further three years. (Extended tax holidays are given for enterprises using advanced technology or engaged in other preferred activities.)
- Sri Lanka provides a standard five-year tax holiday for investors introducing advanced technology, with longer holidays for large investments.
- In Poland's special economic zones, investors can enjoy a complete exemption for 10 years, with a further 50% profit exemption for a period of up to 10 years.
- Jamaica offers 15-year tax holidays to some investors, with complete exemption for investment in its special zones.

In determining the length of the tax holiday to be given, there is a clear trade-off between the attractiveness to investors, on the one hand, and the cost to the host country's treasury, on the other. The tendency in recent years has been towards longer holiday periods.

b) Commencement

The effective duration of a tax holiday depends on the point in time from which the holiday period begins to run. Among the various possibilities are:

- The date of incorporation or registration of the enterprise.
- The date on which production or business commences.
- The date on which the enterprise first receives revenue, or
- The year in which the enterprise first makes a profit.[7]

Obviously, the later the commencement date, the more tax relief available to the investor, and the greater the revenue loss to the host country. In many cases, it is a year or more after the investment has been approved before operations actually commence and often as long as five years or more before the investment begins to show a profit.

In deciding the commencement date, policy-makers may take into account a number of factors. The simplest system is that where the holiday begins on the date of registration, since it is less prone to dispute. However, an early commencement date is of greatest benefit to those investments that show a quick profit, and such investments may not be the most desirable from the perspective of the host country. A holiday commencing on the date that production begins, or the first sale is made, may be more equitable, but may not be suitable for all types of investment. Commencing the holiday in the first profitable year presents opportunities for manipulation, by accelerating receipts or deferring expenditures, at both the beginning and end of the period, and also requires the investor to file proper tax returns during the holiday period. That, however, is probably a desirable feature, since it provides the host government with information about the progress of the investment and better enables it to estimate the cost of the incentive.

It is also important to make clear what is meant by "first profitable year". Is it the first year in which the business records a profit (i.e. a surplus of receipts over expenditures), or is it the first year in which it has *taxable* income, after allowing for the carry-forward of losses from previous years?

c) Depreciation and Loss Rules

The relationship of the tax holiday to the general provisions in the tax code for depreciation and loss relief is of major importance. Two key questions are as follows:

- Are depreciation allowances automatic or elective (i.e. can they be deferred until after the end of the holiday period)? and
- May losses incurred during the holiday period be carried forward and, if so, for how long?

Where, under typical "normal" tax rules, losses from previous years and unused depreciation allowances can be carried forward (or the claim for the allowances may be deferred), it may be several years after a business starts to show a profit before it has any taxable income. If depreciation and loss relief are "lost" during a tax holiday period, as is sometimes the case, the benefit conferred by the tax holiday is greatly reduced and it may even have a negative effect on the investor.

Normal depreciation costs and other deductible business expenses should in principle be matched (setoff) against gross revenues in the same year as the costs are incurred (under the assumption that the factor inputs that the charges represent generate the same-period gross revenues). With a tax holiday, pressures mount on government to allow business costs incurred over the holiday period (that generally would otherwise be tax deductible as incurred) to be carried forward. Deferral of these charges tends to overestimate costs in the post-holiday period. In effect, loss carry-forward provisions allowing firms to carry holiday expenses forward in effect shift post-holiday taxable income into tax-exempt holiday period. If business losses incurred during a holiday are not recognised (deductible) in the post-holiday period, a tax holiday may actually *increase* a firm's tax burden. This factor is particularly relevant for projects with significant costs in initial production years (work-force training costs, advertising costs to establish local market).

Indeed, generous loss carry-forward provisions may provide a greater investment stimulus than a tax holiday with restrictive loss carry-forward rules, as illustrated when comparing table 2-1., which considers a tax holiday with no loss carry-forward provisions, with table 2-2. which considers alternative loss carry-forward rules. The illustrative results show that the present value (PV) of corporate income tax paid is lower with a two-year loss carry-forward and no tax holiday (Case 2B) compared with a two-year tax holiday starting with the fist year of production, but without loss carry-forward provisions (Case 1A). Five-year loss carry-forward rules are also shown to be more attractive than an enriched two-year tax holiday that does not begin until the first year of profit.

d) Tax-planning opportunities under tax holiday regimes

Of the range of corporate tax incentives, perhaps the most often tried and yet the most open to taxpayer abuse is the tax holiday. By exempting certain companies or activities from income tax, tax holidays encourage corporate groups to shift taxable income (within or outside the letter of the law) to qualifying companies to minimise their overall host country tax liability. A number of avenues may be open for this. First, where a tax holiday is targeted at "newly established" companies, taxpayers will attempt to transfer capital from existing businesses to qualifying firms to benefit from the tax relief. This "churning" of business capital for tax purposes can lead to the false impression that new investment has taken place, when in fact the introduction of "new" productive capacity merely reflects a reduction in operating capital elsewhere in the economy.

Another common technique for profit shifting under a tax holiday is routing interest and other deductible payments within a corporate group through tax-free entities. For example, in the absence of a tax holiday, interest on loans by a parent company to its subsidiary, while deductible against the income tax base of the subsidiary, is taxable in the hands of the parent (included in its taxable income). However, where an existing or newly created subsidiary qualifies for a holiday, incentives exist to route interest payments from other non-qualifying subsidiaries through the qualifying subsidiary (via tax-motivated financial restructuring). In this case, the interest receipt becomes non-taxable in the hands of the qualifying subsidiary in its role as a financial intermediary (in the absence of special base protection rules). The interest income can then be converted to dividend income and paid out to, and received tax-free, in the hands of the parent.

A third technique is to use artificial transfer prices in transactions amongst firms in a corporate group that includes a subsidiary qualifying for holiday treatment. Again the incentive exists to shift otherwise

Table 2-1. **Illustration of Two-Year Tax Holiday Under Alternative Commencement Rules**

Investment: 100

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*	*Total*	
Revenue	15	25	30	40	50	50	50	50	50	50	410	
Start-up costs	50	30	10	0	0	0	0	0	0	0	90	
Net revenue	-35	-5	20	40	50	50	50	50	50	50	320	
Depreciation	10	10	10	10	10	10	10	10	10	10	100	
Profit	-45	-15	10	30	40	40	40	40	40	40	220	
Net cumulative profit	-45	-60	-50	-20	20	60	100	140	180	220	-	
Case 1A – Holiday begins 1st year of production												
	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*	*Total*	**PV Tax**
Taxable income	0	0	10	30	40	40	40	40	40	40	280	73
Case 1B – Holiday begins 1st year of profit												
	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*	*Total*	**PV Tax**
Taxable income	0	0	0	0	40	40	40	40	40	40	240	59
Case 1C – Holiday begins 1st year of net cumulative profit												
	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*	*Total*	**PV Tax**
Taxable income	0	0	0	0	0	0	40	40	40	40	160	36

Examples assume 10 year straight-line depreciation for tax purposes, no loss carry-forward provisions.
Present value calculations use a discount rate of 10%, and assume a corporate income tax rate of 50%.

Table 2-2. **Illustration of Alternative Loss Carry-forward Rules**

Investment: 100

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*	*Total*	
Net revenue	-35	-5	20	40	50	50	50	50	50	50	320	
Depreciation	10	10	10	10	10	10	10	10	10	10	100	
Profit	-45	-15	10	30	40	40	40	40	40	40	220	
Case 2A — No loss carry-forward												
	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*	*Total*	**PV Tax**
Taxable income	0	0	10	30	40	40	40	40	40	40	280	73
Case 2B – Two-year loss carry-forward												
	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*	*Total*	**PV Tax**
Unused 2nd prior year loss	0	0	45	15	0	0	0	0	0	0	-	
Unused 1st prior year loss	0	45	15	0	0	0	0	0	0	0	-	
Prior year losses used	0	0	10	15	0	0	0	0	0	0	25	
Taxable income	0	0	0	15	40	40	40	40	40	40	255	65
Case 2C – Five-year loss carry-forward												
	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*	*Year 7*	*Year 8*	*Year 9*	*Year 10*	*Total*	**PV Tax**
Unused 5th prior year loss	0	0	0	0	0	0	0	0	0	0	-	
Unused 4th prior year loss	0	0	0	0	5	0	0	0	0	0	-	
Unused 3rd prior year loss	0	0	0	35	15	0	0	0	0	0	-	
Unused 2nd prior year loss	0	0	45	15	0	0	0	0	0	0	-	
Unused 1st prior year loss	0	45	15	0	0	0	0	0	0	0	-	
Prior year losses used	0	0	10	30	20	0	0	0	0	0	60	
Taxable income	0	0	0	0	20	40	40	40	40	40	220	53

Examples assume same project specifics as Table 2.1, and 10-year straight-line depreciation.
Present-value calculations use a discount rate of 10%, and assume a corporate income tax rate of 50%.

taxable income to the holiday firm, and to shift expense to non-qualifying firms to reduce aggregate income subject to tax.[8] With transactions being amongst members of a corporate group, aggregate pre-tax income of the group is unchanged, but with profits of taxable firms reduced, the total tax bill falls. Artificial or "non-arm's length" pricing may be applied in the context of inter-affiliate loans (e.g. charging interest on loans above the market rate) and in the case of inter-affiliate trade in intermediate or final goods and services.

These basic forms of tax planning that can arise in the context of a tax holiday are illustrated in Annex I. The illustrative effects are summarised in table 2-3. (see also Annex I). Table AI-2. in the Annex illustrates the desired outcome of a tax holiday with reference to a base case (pre-holiday) scenario shown in table AI-1.

In particular, following the introduction of a tax holiday, a parent company (PCo) is shown to invest $500 in a new subsidiary (OpCoB) that undertakes activities that qualify for tax-holiday treatment. The last two tables show unintended yet common responses to a holiday regime. The parent is shown in table AI-3. to reduce its own operations by $500 and divert this capital to OpCoB in order to avoid tax on income generated by the pre-holiday capital stock. Table AI-3. also shows the incentive to structure loans to the pre-holiday operating company (OpCoA) through the new subsidiary (OpCoB). This enables interest to be received tax-free by OpCoB and paid to the parent in the form of a tax-free inter-corporate dividend. Together, these distortions lower host country tax revenues to $65, as compared to the $100 collected from the corporate group under the base case scenario and under the "pure" tax holiday regime (before taking into account tax avoidance incentives). The fourth table AI-4. shows the additional incentive to charge OpCoA a non-arm's length interest rate on loans to reduce host country tax revenues further (to $55). As reviewed in Annex I, these tax effects imply increased post-tax rates of return and thus increased incentive to invest in the *non-targeted* sector.

Table 2-3. **Summary of Tax Planning Opportunities and Illustrative Host Country Tax Effects**
(*with reference to* Tables AI-1. *to* AI-4. *in Annex* I)

		Debt financing for OpCoA) (non-targeted activities		Transfer pricing between corporate groups		
	Recharacterise "old" capital as "new" capital	Direct	Intermediated (via tax-holiday firm OpCoB)	Arm's length	Non-arm's length	Host CIT revenues
Base case (TAB1)	not applicable	Yes	not applicable	Yes	No	100
Tax holiday:						
Intended impact (TAB2)	No	Yes	No	Yes	No	100
Tax planning I (TAB3)	Yes	No	Yes	Yes	No	65
Tax planning II (TAB4)	Yes	No	Yes	No	Yes	55

e) A Critique of Tax Holidays

Tax holidays have the apparent advantage of simplicity from the point of view of both the enterprise and the tax authorities. For tax authorities in countries in the early stages of transition or reform, tax holidays may appear attractive as they can be offered even if tax administration is still in a formative stage. If no tax is payable during the holiday period, then it would appear that tax administration (and tax compliance) is not required. Indeed, one of the main attractions of tax holidays, for some investors, is that it saves them from having to deal with incompetent or corrupt tax administrations, at least for a time.[9]

In practice, however, it is usually still necessary (and desirable) to require the filing of a tax return during the holiday period. In particular, if the enterprise is allowed to carry forward losses incurred in the holiday period or to claim depreciation allowances after the end of the holiday for expenditure incurred during the holiday, the enterprise will obviously need to file a return or at least keep appropriate records.

Most studies have concluded that short tax holidays are of limited value or interest to most potential investors and are rarely effective in attracting investment, other than short-term, “footloose” projects. Substantial investments often take several years before they begin to show a profit, by which time the tax holiday may have expired.[10] Short tax holidays are of the greatest value to investments that can be expected to show a quick profit and are consequently quite effective in attracting investment in export-oriented activities such as textile production. Since that sector is highly mobile, however, it is not uncommon for a firm to enjoy a tax holiday in one country and, when it expires, to move its entire operation to another country that is willing to give a new holiday. Consequently, the benefit of the investment to the host country may be quite limited.

Longer holidays are obviously likely to be a more effective inducement, but they increase the cost to the host country in terms of the amount of tax foregone. Further objections are that the cost of tax holidays cannot be estimated in advance with any degree of accuracy, nor is the cost related to the amount of the investment or to the benefits that it is hoped will accrue to the host country. Additionally, as elaborated above, tax holidays are especially prone to manipulation and provide opportunities for tax avoidance and abuse. Also, expenditures are often deferred until after the end of the holiday period (to obtain tax relief in respect of those expenditures), so that the existence of the tax holiday may actually act as a deterrent to additional capital investment. Instead of existing operations being expanded, new companies are formed to obtain additional holidays and, in some cases, businesses are transferred to related companies and new tax holidays claimed. Thus, despite their popularity, tax holidays are perhaps the least effective, and almost certainly the least efficient, of all types of tax incentive.[11]

3. *Investment Allowances and Credits*

As an alternative, or sometimes in addition, to tax holidays, some governments provide investment allowances or credits. These are given in addition to the normal depreciation allowances, with the result that the investor is effectively able to write off an amount that is more than the cost of the investment. An investment allowance reduces taxable income, whereas an investment tax credit is set against the tax payable; thus, with a CIT rate of 40%, an investment allowance of 50% of the amount invested equates to an investment credit of 20% of that amount. In order to be effective, the investor should be entitled to carry forward the unused part of the allowance or credit indefinitely or at least for a substantial period.

Investment allowances or credits may apply to all forms of capital investment, or they may be restricted to specific categories, such as machinery or technologically advanced equipment, or to capital investment in certain activities, such as research and development. Sometimes, eligibility is restricted to contributions to the charter capital of the enterprise: this encourages equity investment and counteracts to some extent any incentive for thin capitalisation.

Investment allowances and credits are preferable to tax holidays in almost every respect as:

- They are not open-ended.
- Their cost is directly related to the amount of the investment, so there should be no need for a minimum threshold for eligibility, and
- Their maximum cost is easily determined.

Perhaps because of these advantages, and the advice received from various agencies such as the IMF and World Bank, there does seem to be a trend away from tax holidays in favour of investment allowances or credits. Since the beginning of 2000, several countries have introduced them, in some cases replacing existing tax holidays. Those countries include Kenya, Latvia, South Africa, Swaziland and Turkey.

One possible objection is that they encourage capital-intensive investment and are thus less favourable towards employment creation than are tax holidays. They may also distort the choice of capital assets, possibly creating a preference for short-lived assets so that a further allowance or credit may be claimed on

replacement. There is also potential for abuse: assets may be overvalued to increase the allowance or credit, and assets may be sold once the allowance or credit has been received.

An investment allowance should be distinguished from what is sometimes called an «initial allowance». A typical initial allowance would permit, for example, 40% of the cost of a depreciable asset to be written off in the first year, with the remaining 60% written off over a number of years. It does not allow a deduction for more than 100% of the cost, and is therefore really a form of accelerated depreciation.

4. Depreciation Allowances and "Accelerated" Depreciation

As already noted, an investment credit or allowance is provided in addition to any amount of depreciation that may be claimed. The term "accelerated depreciation", by contrast, is used with several different meanings. Depending on the context, it may denote that:

- Capital costs are written off, for tax purposes, at a rate that is faster than true economic depreciation.
- The "declining balance" method of depreciation is allowed, whereby larger deductions may be claimed in the earlier years after acquisition (i.e., greater than under the more common "straight-line" method).
- Capital costs of targeted assets may be written off more quickly than would be allowed under the normal depreciation schedules.

In the context of (targeted) tax *incentives*, meaning provisions that are more advantageous than those generally available in the tax system, the last bullet applies. Whether a country has a standard depreciation regime that is "generous", and thus encourages investment, is another question; the issue here is whether it provides a special (more favourable) depreciation regime that is available to some, but not all, investors.

The cost of accelerated depreciation to the host country, in terms of tax revenue foregone, is normally less than that of tax holidays or investment allowances/credits, since it is only the timing of the tax payable, and not the amount of tax, that is affected. That, of course, can still be a substantial benefit to established businesses that are planning to increase their investment, but in the case of most initial investments, where there may be no profit for several years, accelerated depreciation will be of no immediate benefit, and may actually result in an increased tax burden unless depreciation allowances are elective or losses can be carried forward in full.

For all countries with an income tax, a key consideration is the treatment of the cost of depreciation of physical capital in measuring taxable income.[12] Indeed, the rules that govern the treatment of depreciable capital costs for tax purposes are a central element of a corporate income tax system, determining whether firms are able (or not) to recover their investment costs.[13] Where tax allowances are restrictive, the effective tax rate on investor profits can exceed the statutory corporate tax rate, perhaps significantly, tending to discourage FDI.[14]

Given that the treatment of depreciation expenses is a central element of an income tax system, it is somewhat surprising that many developing and transition economies have in place depreciation rules that are anything but investment-friendly.[15] This is especially so where the host country offers a range of tax incentives to encourage FDI. It such cases, it would seem that getting the basics right should be a priority item over special tax "add-ons" that can greatly complicate the tax system.

Depreciation treatment may impede FDI if it is unnecessarily complex and/or restrictive. In general, the objective of a depreciation allowance system is to provide the taxpayer with a deduction for the normal wear and tear of an ageing asset (reflected in theory in the original purchase price), and possibly reductions in asset values owing to technological obsolescence.[16] Providing adequate tax relief in respect of these costs is complicated by a number of factors. For example, different assets depreciate at different and possibly fluctuating rates, which generally are not known with certainty by the tax authorities.[17] Requiring separate treatment of depreciable costs for each capital asset purchased may be burdensome to taxpayers in terms

of compliance costs, while grouping assets to simplify tax-filing is not without tradeoffs (e.g. simplicity vs. efficiency).[18] Furthermore, where balances of undepreciated capital costs are maintained on a historic cost basis, problems in providing adequate cost allowance are met during inflationary periods, while attempts to provide inflation-adjustments, with reference to year-to-year movements in general price indexes, may be seen as too approximate or complicated.

Depreciation systems are restrictive where they depreciate capital at rates that are too slow (relative to assumptions over "true" economic depreciation rates), and/or provide limited scope for carrying forward unclaimed depreciation allowances. Where depreciation claims are mandatory, interactions between depreciation rules and business loss carry-forward rules are very important.

Countries in the early stages of developing their corporate tax systems would be well advised to adhere to a relatively simple depreciation system that would rely on a small number of depreciable asset categories (e.g. 5-6 or fewer),[19] varying according to the assigned recovery period.[20] In general, the category with the longest recovery period would include buildings (typically the asset with the longest productive life), depreciated on a straight-line basis. At the other extreme, the category with the shortest recovery period could include computers, office furniture, commercial cars and trucks, and possibly other assets with relatively short productive lives. Countries can look to approaches in other countries to establish an appropriate mapping of various types of machinery and equipment to depreciable asset categories in between.[21]

As regards depreciation methods, the declining-balance approach offers a number of advantages over alternatives. Perhaps the most important is that it allows for the pooling of assets within a given depreciable asset category, eliminating the need to keep separate accounts of unclaimed depreciation balances for each asset in a given category.[22] With pooling, the depreciable cost of newly acquired capital is simply added to the balance of the (aggregate) amount of undepreciated capital cost for the category to which the asset is assigned. Furthermore, the declining-balance approach, combined with fairly simple rules covering asset dispositions, provides a relatively simple mechanism for the treatment of capital gains, capital losses and depreciation recapture.[23]

Also, for many assets, the geometric rate of depreciation captured by the declining-balance method, which is "front-end loaded", providing larger allowances in earlier years over the asset's life, may conform relatively well to actual patterns of depreciation. At least, the profile of allowances may be more accurate than under the straight-line method, which may be best suited and restricted to long-lived assets, such as buildings. However, this potential advantage should not be overstated, as the declining-balance method – like other scheduler approaches that set allowances independently of taxpayer conditions that determine true depreciation (e.g. intensity of use) – can at best provide for economic depreciation in some average sense.

In managing a transition to declining-balance for one or more categories of assets, the closing balances of undepreciated capital cost (depreciated previously according to some other method) can be transferred, perhaps with an adjustment, to the opening balances of the corresponding asset categories established under the revised regime. The pooling feature of the declining-balance method offers scope for simplification where the number of depreciable asset categories is collapsed. Adjustments may be introduced to ensure, at least on an approximate basis, that the present value of the stream of allowances under the new regime does not fall below that allowed under the previous regime.[24]

Closely tied to the choice of depreciation methods, and the assignment of recovery periods to depreciable assets, is the generosity of the depreciation system in providing tax relief in respect of investment costs. Depreciation systems, even simplified approaches, can act to deter FDI where the present value of depreciation allowances is judged to be too low relative to true economic depreciation, or too low relative to that available in other countries, or possibly against some other standard.[25]

The present value of depreciation claims on a given asset is influenced by a number of factors, including the depreciable base, the depreciation rate and method, the tax-loss position of the firm, the tax treatment

of losses (see below), and actual and expected rates of inflation. Under standard practice, the depreciable base is determined with reference to the purchase price, plus possibly costs in preparing the asset for use. However, considerable scope exists in providing attractive deprecation methods and rates, with the policy choice having important implications as regards the cost of capital and investment incentives, assuming that other "enabling conditions" are in place.

Under most systems, the depreciation rate for a given asset depends on its recovery period (or the recovery period of the depreciable asset category to which the given asset is assigned), as set out by statute. The shorter the stipulated recovery period, the higher the effective depreciation rate. In principle the recovery period should reflect the average productive life of the asset or asset group, with pioneering work by Hulten and Wykoff (1981) providing perhaps the most widely cited basis for establishing productive lives of asset groups, and by extension, benchmark economic depreciation rates. Yet while recent reviews have generally reaffirmed the Hulten and Wykoff estimates as providing useful benchmarks in the U.S. context,[26] it can be argued – particularly in the context of developing or transition economies where inflation rates are relatively high – that shorter recovery periods (higher depreciation rates) are appropriate.

As argued above, other than in the case of buildings, a preference should exist for the declining-balance method, given the simplicity and other advantages that it brings to the system. Depreciating assets in a given category on a standard (100%) declining-balance basis provides less tax relief, on a present-value basis, than that under the straight-line method, assuming the same recovery period under both methods.[27] Thus countries may consider stipulating, for one or more categories, "double-declining balance" which applies double the (standard) declining-balance rate, while stipulating other multiples (scalars) to other categories. In general, the choice of scalars for each of the categories depreciated on a declining-balance basis should take into account estimates of the true productive lives of the underlying assets (used to group those assets), so as to not impart significant distortions in investor choice across assets.[28]

It is important to recognise that applying scalars can accelerate depreciation – that is, apply a faster effective rate of depreciation relative to that corresponding to an estimate of the true economic depreciation rate. This shifting-forward in time of allowed tax deductions is attractive, both to investors who see the present value of depreciation claims increase (and likewise their after-tax rate of return on investment), and to policy-makers. Accelerated depreciation is attractive compared to other fiscal incentives on a number of counts. Unlike tax credits, accelerated depreciation does not create additional offsets against tax revenues, but a shifting-forward in time of those offsets. Also, unlike tax credits, the taxpayer does not need to keep separate (additional) accounts to track unclaimed balances, as these are part of the basic depreciation system.[29] Furthermore, unlike tax credits, accelerated depreciation generally does not impart a bias in favour of short-lived assets.[30] And finally, with recapture features built into depreciation systems, investors are discouraged from "churning" (selling and repurchasing) assets to obtain multiple amounts of tax relief in respect of the same asset.

a) Loss Relief

Apart from the statutory rate, the corporate tax consideration that is often of greatest concern to new investors is the system providing relief for losses. Firms making substantial new investments in a country may not expect to become profitable for several years. Large investments in manufacturing, which are typically the type of investment that countries are most eager to attract, may not begin to make a profit for five years or more. For such firms, the ability to carry forward these start-up losses as an offset against future taxable profits is of the utmost importance.

The international norm for loss carry-forward is to provide a minimum of five to seven years, with many countries allowing a longer period. Germany, Sweden and the U.K., for example, provide for unlimited loss carry-forward.[31] In the U.S., business losses can be carried forward for 20 years.

As noted in the previous section, an interaction exists between the depreciation rules of a tax system and its loss carry-forward rules. The interaction is simply one where a depreciation allowance claim

(deduction) of, say, one euro, is converted into an (additional) business loss of one euro, which can arise where a firm is non-profitable so that additional deductions from taxable income result in a larger tax loss. This inter-action and the rules governing loss carry-forwards become critically important where depreciation claims are mandatory. More generally, where depreciation rules require that capital cost allowances be claimed as they are earned (rather than allowing for a carry-forward of those allowances), or where depreciation allowances can be carried forward but only for a relatively limited number of years, the ability to obtain tax relief in respect of those allowances critically depends on the generosity (or lack of it) under the corporate tax system's loss carry-forward rules.

Where loss carry-forward rules are generous, for example providing for unlimited loss carry-forward for an indefinite number of years, then the potential constraint imposed by mandatory depreciation claims is relaxed. In particular, tax relief may be realised with the conversion of depreciation allowances into business losses, euro-for-euro. The losses can be used to offset tax, depending on the taxable profits of the firm over time – which determines its ability to absorb the losses – and the number of years that losses can be carried forward. Where loss carry-forward rules are restrictive – for example, requiring that losses realised in one year must be claimed over the following three years, with any unclaimed balance at the end of that period becoming no longer available for a deduction – then even accelerated depreciation rules may be regarded, in effect, as being restrictive.

Table 2.4 illustrates how mandatory capital cost allowance claims, when combined with restrictive loss carry-forward rules, can interact to increase corporate tax liabilities, tending to depress investment. The illustration considers a single investment project of $100, with start-up (e.g. marketing) costs, and a gradually building revenue stream that leaves the firm non-profitable for two years. In case A, the capital cost of $100 is depreciated over 10 years on a straight-line basis. The firm becomes taxable in year 5, and pays a total of $45 in tax over the ten-year period. The present value of tax liabilities, assessed in the first year, is $30.3.

In case B, the firm is provided with accelerated depreciation where claims continue to be mandatory and loss carry-forward continues to be capped at 3 years.[32] The inter-action of these rules results in much of the capital cost being non-deductible. In particular, only $13.8 of the $65 loss in the first year is offset against profit – the remainder is lost. This restriction is shown to increase the present value of total CIT paid to $38.1, a tax burden more than 25% higher than in case A, despite the acceleration incentive.

In case C, the firm is provided with seven-year rather than seven-year loss carry-forward. Under these liberalised rules, the initial losses realised by the firm are eventually fully set off against profits, providing a significant reduction in the corporate tax burden. The present value of the corporate tax liabilities, at $26.2, would be judged favourably by investors compared to that under the non-accelerated treatment, with the result made possible by more flexible loss carry-forward rules falling within the range of what would be expected under international norms.

These examples serve merely to illustrate the importance of carefully examining the interaction between a country's depreciation system and loss carry forward rules in order to establish whether desired effects, as regards investment incentives and tax revenues, are being met. Where accelerated depreciation is being sought as a form of investment incentive, but existing loss carry forward rules would operate to deny firms a reduction in tax liabilities (perhaps increasing capital costs, as illustrated in case B), countries would be well advised to consider whether their loss carry forward rules can be relaxed. This would involve assessing the costs that lifting the loss restrictions would entail, relative to the expected net benefits of the investment incentive.

5. *Favourable Deduction Rules*

One way of promoting desirable investor behaviour is to provide favourable rules for the deduction of certain types of expenditures incurred. Accelerated depreciation provisions fall into this category, as do rules that allow the immediate expensing of what are really capital outlays.

A somewhat different type of incentive, popular in Malaysia and Singapore, although rarely encountered elsewhere, is the double (or multiple) deduction of preferred expenditures. Both of those countries allow double deduction for a variety of expenditures that are designed to promote exports or the performance of services for foreign clients. Malaysia also allows double deduction for some expenses related to tourism and to employee training.

A double deduction reduces the taxpayer's taxable income and operates in much the same manner as a "matching grant" from the host government. For example, if the taxpayer expends $1 million on training employees in new skills, it is permitted to deduct $2 million in computing its taxable income. At a CIT rate of 30%, the host government effectively contributes an additional $300,000 to the cost of training. (The deduction does not, of course, necessarily have to be double the amount of expenditure: it could be a 150% or 300% deduction.)

Table 2-4. **Illustration of Accelerated Depreciation, 3-year vs. 7-year Loss Carry-forward**

Year	1	2	3	4	5	6	7	8	9	10	Total
Investment=100											
Revenue	0	10	15	25	30	35	40	45	50	50	
Wages	5	5	5	5	5	5	5	5	5	5	
Start-up costs	10	5	0	0	0	0	0	0	0	0	
Net revenue	-15	0	10	20	25	30	35	40	45	45	
Case A - Economic depreciation (mandatory), 3-year loss carryforward											
Economic depreciation	10	10	10	10	10	10	10	10	10	10	100
Taxable profit (current year)	-25	-10	0	10	15	20	25	30	35	35	
Unused 3rd prior year loss	0	0	0	25	10	0	0	0	0	0	
Unused 2nd prior year loss	0	0	25	10	0	0	0	0	0	0	
Unused 1st prior year loss	0	25	10	0	0	0	0	0	0	0	
Prior year loss claim	0	0	0	10	10	0	0	0	0	0	
Taxable profit	0	0	0	0	5	20	25	30	35	35	
CIT(@30%)	0.0	0.0	0.0	0.0	1.5	6.0	7.5	9.0	10.5	10.5	45
Present value CIT	0.0	0.0	0.0	0.0	1.2	4.5	5.3	6.1	6.8	6.4	30.3
Case B - Accelerated depreciation (mandatory), 3-year loss carryforward											
Accelerated depreciation	50.0	25.0	12.5	6.3	3.1	1.6	0.8	0.4	0.2	0.1	99.9
Taxable profit (current year)	-65.0	-25.0	-2.5	13.8	21.9	28.4	34.2	39.6	44.8	44.9	
Unused 3rd prior year loss	0	0	0	65	25	2.5	0	0	0	0	
Unused 2nd prior year loss	0	0	65	25	2.5	0	0	0	0	0	
Unused 1st prior year loss	0	65	25	2.5	0	0	0	0	0	0	
Prior year loss claim	0	0	0	13.8	21.9	2.5	0	0	0	0	
Taxable profit	0	0	0	0.0	0.0	25.9	34.2	39.6	44.8	44.9	
CIT(@30%)	0.0	0.0	0.0	0.0	0.0	7.8	10.3	11.9	13.4	13.5	56.8
Present value CIT	0.0	0.0	0.0	0.0	0.0	5.8	7.3	8.0	8.7	8.3	38.1
Case C - Accelerated depreciation (mandatory), 7-year loss carryforward											
Accelerated depreciation	50.0	25.0	12.5	6.3	3.1	1.6	0.8	0.4	0.2	0.1	99.9
Taxable profit (current year)	-65.0	-25.0	-2.5	13.8	21.9	28.4	34.2	39.6	44.8	44.9	
Unused 7th prior year loss	0	0	0	0	0	0	0.0	0	0	0	
Unused 6th prior year loss	0	0	0	0	0	0	0.9	0	0	0	
Unused 5th prior year loss	0	0	0	0	0	29.4	25.0	0	0	0	
Unused 4th prior year loss	0	0	0	0	51.3	25.0	2.5	0	0	0	
Unused 3rd prior year loss	0	0	0	65	25	2.5	0	0	0	0	
Unused 2nd prior year loss	0	0	65	25	2.5	0	0	0	0	0	
Unused 1st prior year loss	0	65	25	2.5	0	0	0	0	0	0	
Prior year loss claim	0	0	0	13.8	21.9	28.4	28.4	0	0	0	
Taxable profit	0	0	0	0.0	0.0	0.0	5.8	39.6	44.8	44.9	
CIT(@30%)	0.0	0.0	0.0	0.0	0.0	0.0	1.7	11.9	13.4	13.5	40.5
Present value CIT	0.0	0.0	0.0	0.0	0.0	0.0	1.2	8.0	8.7	8.3	26.2

Example assumes $100 investment project undertaken in year 1. Present value calculations assume a 5% discount rate.

6. Reinvestment Incentives

Some countries, including China, Malaysia and Vietnam, provide incentives for the reinvestment of profits. This can be done in one of two ways:

- The tax liability of the enterprise itself can be reduced by allowing a deduction for the amount reinvested (or a proportion thereof) from the profits otherwise taxable. This is the most common type of reinvestment allowance.
- The shareholder, or parent company, is given a refund of the tax paid by the local enterprise up to a stated proportion of the amount reinvested. This method is used in China, and allows the refunded tax to be reinvested either in the original enterprise that made the profit or in some other qualifying enterprise.

Whether reinvestment incentives are really effective is questionable. Once an enterprise has made its initial investment it will normally base its additional investment decisions on actual business needs, so that the incentive probably rewards the enterprise for doing what it would have done in any event. Provided the host country has a reasonably generous system of depreciation allowances, there would seem to be little need to provide any further inducement to reinvest. Moreover, the international tax system itself provides a built-in incentive to reinvest profits where they are made, rather than repatriating them: reinvesting profits avoids withholding tax in the host country and (usually) also avoids tax liability in the home country.

It should be noted, too, that if investment allowances or credits are used, rather than tax holidays, there is no need for a separate reinvestment allowance.

7. Reduced Withholding Taxes

It is not uncommon for countries to advertise reduced or zero rates of withholding tax as an incentive for foreign investment, either generally or to promote particular objectives such as the transfer of technology. Exemption from withholding tax is sometimes given in the case of interest on loans made at preferential rates or in the case of royalties or technical assistance fees paid in respect of technology transfers.[33] It is also quite common for dividends paid out of exempt profits (for example, profits earned during a tax holiday period) to be exempt from withholding tax.

There is some evidence that high withholding tax rates provide a disincentive to FDI, although it is less clear that exemptions, or reductions to rates that are below the international norms, will have much if any effect on initial investment decisions. This is also one case where reduced host-country tax will increase home-country tax liability, unless there is tax-sparing or the payments are routed through a country that does not tax them. Further, this form of relief actually reduces the incentive to reinvest profits, by reducing the disincentive to repatriate them. It is therefore rather surprising that some countries (e.g. China) provide both reinvestment incentives and reduced withholding taxes.

8. Personal Income Tax, Social Security Contribution and Property Tax Reductions

Some countries accord special tax treatment to "expatriate" executives and employees, such as the granting of additional allowances (accommodation, children's education, home leave, etc.). Other countries go further and exempt certain categories of expatriate employees from income tax or payroll taxes or tax them at lower rates than other resident individuals. In Vietnam, for example, expatriates pay the top 50% rate of personal income tax on income in excess of VND 120 million per month (about US $8,000); local residents pay the top rate on income exceeding VND 8 million per month.

Concessions of this type are rarely likely to influence investment decisions, although they may be perceived by investors as one of the factors that make for a favourable investment environment. They can also sometimes be justified on the basis of the increased expenses that are often incurred by expatriates

and by the fact that expatriates might otherwise be contributing to social security schemes from which they would be unlikely to benefit.

Reductions in payroll taxes and social security contributions are also sometimes used as an incentive to invest in regions of high unemployment or to employ certain categories of workers (e.g. youths or the disabled). Such incentives are likely to be moderately effective, especially in countries where payroll taxes and social security contributions form a substantial part of the cost of employment, and they have the advantage of being relatively simple to administer.

9. *Sales Tax Exemptions*

Exemptions from sales taxes, such as VAT, are sometimes provided as an inducement to foreign investors,[34] although it is difficult to see how such provisions can provide any real incentive. Generally, indirect taxes should be of little concern to investors, whether domestic or foreign. In theory, those taxes are borne by consumers rather than by businesses. Even if, in reality, they are in part absorbed by business, the same taxes must be borne by competitors, and for export-oriented investment, consumption taxes are normally remitted on exportation. There are, however, some situations in which taxes such as VAT become important. For example:

- If the enterprise exports a large proportion of its total production, it may have insufficient domestic supplies to offset the VAT paid on its purchases. In such a case, it ought to be entitled to a refund of input VAT. Some tax administrations, however, are notoriously reluctant, or slow, to make refunds. In countries with a high rate of inflation, VAT refunds – if they are eventually made – may be worth a small fraction of the tax originally paid.
- A substantial amount of VAT may be paid on the purchase – or importation – of machinery and other types of capital goods. Although that VAT should eventually be recaptured through the credit mechanism, it may be several years before a new investment commences full production and has sales against which to set the credits.

The better approach to these problems is to improve the VAT legislation, in particular by providing prompt refunds rather than by granting exemptions.

10. *Reduced Import Taxes and Customs Duties*

Among developed countries, customs duties are rarely a major burden. In developing countries, by contrast, they are often one of the more important sources of national revenue and are imposed at relatively high rates. Their chief effect is to increase – sometimes substantially – the cost of imported raw materials, components and capital goods. While the taxes or duties on raw materials and components will presumably be passed on to domestic consumers, or remitted on re-export, the taxes on capital goods may be less easily recovered and can add substantially to the initial cost of an investment. For example, when the Chinese Government announced its intention in 1996 to remove the exemption from duty and tax on the import of capital equipment by foreign-invested firms, it was estimated that this would increase the cost of such equipment by as much as 36%.[35]

Exemption from customs duties and import taxes can consequently be an important factor in investment decisions and is considered by many investors to be the most valuable of all types of investment incentive. This form of incentive also has the considerable advantage that it is not dependent on profitability: it is an "up front" benefit and constitutes an immediate saving to the investor, reducing the initial cost of the investment.

Exemption normally applies only to imported capital equipment. Sometimes all capital equipment qualifies; in other cases, only certain categories qualify, such as machinery or technologically-advanced equipment. Occasionally, however, exemption also extends to imported components and raw materials to be used in production, although such exemptions are usually granted only on a temporary basis. Exemptions of this

nature, especially when granted selectively to particular investors, can severely distort competition and may be contrary to international trade rules.

As with investment allowances and credits, there is a risk that goods imported free of duty will subsequently be sold on the domestic market, and it may be prudent to exclude from the exemption such readily saleable articles as automobiles.[36] In some countries, it is only the foreign investor's contribution to the charter capital of the enterprise that qualifies for the exemption, which may lessen the risk of abuse and also reduce the problem of thin capitalisation.

11. *Property Tax Relief*

Exemption from, or reduction of, property taxes is a common and relatively effective form of investment incentive, and it shares with customs duty exemptions the advantage of not being tied to profitability and of conferring an immediate benefit on the investor. Property tax relief has the further advantage, from the granting government's point of view, that its cost is fully predictable. The relief is normally limited in duration, and its effect is much the same as a cash grant spread over a number of years.

Property tax incentives are frequently adopted as part of more general regional development policies and are often granted by local, rather than central, government authorities.

C. Matching the Incentive to the Target

Although much has been written on the subject of investment incentives, relatively little attention has been paid to the question of how to match the particular type of incentive to the chosen objective or target. It would seem important, however, to try to select incentive types that are consistent with the objectives that the incentives are intended to promote.[37]

The widespread use of tax holidays as the principal form of incentive suggests that sufficient thought is rarely given to the design of investment incentives. A tax holiday may be reasonably effective in attracting mobile, quick-profit investment (and even here the tax holiday is often inefficient from a cost/benefit point of view), but otherwise it seems to be an extremely crude instrument that is ill-suited to achieve many of the purposes for which it is granted. To take an extreme example, a tax holiday given for employing a given percentage of disabled workers can have absurd consequences: a small software development firm might obtain a tax holiday by employing a large number of disabled janitors on minimum wage. The same is likely to be true where the policy objective is to promote job creation in disadvantaged regions or regions of high unemployment. To tie tax holidays, or rate reductions, to the number of jobs created, could induce an investor to hire a small number of unneeded workers in order to qualify for the tax reduction: the cost, to the host country, of those few additional jobs could be astronomical. If employment creation is the objective, it would obviously make far better sense to provide an exemption from payroll tax or to allow a double deduction for retraining expenses.

Tax holidays for introducing advanced technology similarly make little sense. More appropriate would be an exemption from customs duty on importation of the equipment, an investment allowance or credit based on its cost or a double deduction for software purchases or R&D expenditures.

As a general principle, before introducing investment incentives, policy-makers should ask themselves:

- What are the principal policy objectives being pursued?
- Are tax incentives likely to be a cost-effective method of pursuing those objectives?
- What type of tax incentive (if any) would be most suitable to attain the objectives?

NOTES

1. Zee, Stotsky and Ley, at p.14 (italics added).

2. See UNCTAD (1996) at p.3.

3. See the analysis by Clark, at p.1148 seq.

4. One must distinguish between systems that apply different CIT rates to different types of profit derived from different business activities, and systems that apply a tiered CIT rate structure to a given type or types of profit. Section B.1) refers to the former.

5. The 10% manufacturing rate is being replaced by a standard (general) corporate tax rate of 12.5% for 2003 and thereafter.

6. The Canadian reduced M&P tax rate (currently being phased out) is applied by providing a deduction for qualifying M&P profits. Prior to the phased in elimination of this measure, the M&P profits reduction was at 7 percent, lowering the basic federal statutory CIT rate on M&P profits from 28% to 21%.

7. That date, in turn, will depend on the treatment of depreciation and losses — see below.

8. McLure, at 327, calls transfer pricing «the Achilles heel of tax holidays».

9. See the comments of Chalk (at p.18) on tax holidays in the Philippines.

10. That depends, in part, on when the holiday commences. In their study of FDI in Central and Eastern Europe, Gray and Jarosz (at p.35) found that many investors were unable to make use of the tax holidays they were offered. See also Mintz (1990).

11. As Tanzi and Zee comment (p.316): "Unfortunately, the most prevalent forms of incentives found in developing countries tend also to be the least meritorious." McLure is especially critical of tax holidays and considers their proper administration to be "incredibly complicated". According to Bergsman, "if incentives are being used...FIAS always advises against tax holidays."

12. Under an income-based system, a deduction for depreciation is necessary to properly measure (economic) income, which in turn is a measure of the change in taxpayer wealth.

13. The two main depreciation methods used in OECD countries are the straight-line method, and the declining-balance method (see OECD (1991)). Under the straight-line method, an annual allowance is provided equal to (1/L) times the (historical) cost of the asset, where L is the asset's assigned life (recovery period) in years, as set under depreciation rules. For example, for an asset purchased for $100, depreciated on a straight-line basis with an assigned recovery period of 10 years, the annual depreciation allowance is $10 each year for 10 years. Under the basic declining-balance method, an annual allowance is given equal to (1/L) times the undepreciated value of the asset, where L is the assigned recovery period. Referring to the same example, the first-year allowance would be (1/10)x$100=$10; the second year allowance would be (1/10)x$90=$9; the third year allowance would be (1/10)x$81=$8.1, and so on (note that this geometric pattern means that the capital cost is never fully depreciated – recognising this, taxpayers may be allowed to convert to straight-line depreciation at the point where the present value of allowances under straight-line exceeds that under declining-balance). Where the basic declining-balance depreciation rate, given by (1/L), is regarded as too slow relative to true (economic) depreciation or where accelerated depreciation is sought, countries may rely on a modified system that provides basic (100%) declining-balance for certain asset categories (as in the example), 200% declining-balance for others (so-called 'double declining balance'), applying a depreciation rate of (2/L) to undepreciated asset values; and possibly other scalar coefficients (e.g. 150%). The U.S. and Romanian depreciation systems, for example, apply a modified system.

14. Tax rules that provide for true economic depreciation, allowing investors to recover initial investment costs tax free, effectively tax returns (profits) to investment at the statutory corporate tax rate (note that the effective corporate tax rate may be higher or lower owing to the influence of other tax rules). See Gravelle (1979), and Brazell and Mackie III.

15. See Tanzi and Zee.

16. An asset's value declines over time where, as it ages, it has a progressively shorter productive life, or more generally, becomes less productive in remaining in-use periods. Technological advances embodied in new capital that is more productive, per dollar invested, also reduce the value of installed capital. Tax deductions (depreciation allowances) for these reductions in taxpayer wealth are therefore called for in a system that taxes income. See Brazell and Mackie III.

17. For certain assets, average/normal depreciation rates can be inferred from movements in asset prices in second-hand markets for those assets. However, for certain other assets, observable prices in second-hand markets are not readily available, and must be inferred by other (generally less reliable) means.

18. In general, when grouping assets for depreciation purposes, the aim is to pool together assets that follow roughly the same schedule of economic depreciation in terms of asset life and pattern of the rate of decline in asset value (e.g. straight-line versus geometric decay). Using broadly defined categories simplifies the depreciation system. On the other hand, too broad a classification system may provide too restrictive or too generous relief, relative to true depreciation, for certain types of assets, leading to non-neutral treatment and an inefficient pattern of investment.

19. Tanzi and Zee argue that, under most circumstances, developing countries should rely on three or four asset categories.

20. The general procedure for assigning recovering periods to depreciable assets involves first assigning each individual asset purchased to a relevant "productive life" range (e.g. assets with a productive life of less than 5 years; assets with a productive life more than 5 years but less than 10; assets with a productive life more than 10 years but less than 15; and so on, with the number of categories (specifying a productive life range) equal to (or possibly exceeding) the number of depreciable asset classes (recovery periods)). Under the second step, a recovery period (and depreciation method and depreciation rate) is assigned to each category specifying a productive life range (e.g. assets with a productive life of less than 5 years are assigned a recovery period of 3 years).

21. It is noteworthy that the depreciation system used for U.S. tax purposes continues to be based on an asset classification system developed in 1962, last modified in 1981 – despite significant changes in many sectors in asset types and mix in production. This situation reflects, in part, the difficulties and expense in a systematic reassessment of economic depreciation and appropriate recovery periods for individual assets. Most would agree that the Hulten and Wykoff estimates of depreciation rates are the best available source of information on economic depreciation by asset type, to guide policy making in this area.

22. Given the ever-increasing availability and use of a variety of software packages containing spreadsheet programmes with detailed 'help' facilities (e.g. Microsoft Excel), one would expect that, over time, fewer and fewer taxpayers would resist using such software to keep track of unclaimed balances of undepreciated capital costs for individual assets. Certainly one would expect that virtually all MNEs would rely on such packages, or on accounting firms using such packages. However, since a country's depreciation system must be designed bearing in mind compliance costs for all taxpayers, the declining-balance depreciation method continues to hold out the advantage of offering a reduced compliance burden.

23. A fairly straight-forward approach would require taxpayers, when disposing of a depreciable asset, to deduct the proceeds of disposition from the undepreciated capital cost of the depreciable asset category to which the asset belongs. Where the undepreciated cost of the asset (a notional amount, given the pooling of assets) exceeds the proceeds, the part of the undepreciated amount equal to the proceeds is effectively removed from the accounts, while the excess (representing a loss on the sale, and/or restrictive past depreciation for that asset relative to true depreciation) remains deductible along with the undepreciated costs of the other assets in the same category. Where, alternatively, the proceeds exceed the undepreciated cost of the asset, the undepreciated amount is effectively removed from the accounts, while the excess (representing a gain and/or accelerated depreciation) is deducted automatically from the undepreciated costs of the other assets – this in effect taxes the excess, or recaptures the accelerated portion of previous depreciation claims. In the situation where the proceeds exceed the *original* capital cost of the asset (i.e. a capital gain is realised), the deduction from the depreciable asset category is limited to the original capital cost, with the excess of the proceeds over the original cost subject to the system's normal capital gains tax rules (which may or may not subject capital gains to tax, or perhaps subject gains to tax, but at a reduced (effective) rate). The deduction of the original capital cost from the depreciable asset category removes from the

accounts remaining undepreciated capital cost of the asset, while recapturing past depreciation claims (equal to the original cost less the undepreciated cost). Note finally that where a deduction of the proceeds of disposition (or a deduction of the original capital cost) results in an overall negative balance for the undepreciated capital cost of a given depreciable asset category, the negative amount must be included in taxable income to enable recapture. The salient point is that the desired effects (in terms of treatment of losses, gains, and recapture) can be obtained through a relatively small number of entries and adjustment to the capital cost allowance accounts.

24. Where the assigned productive life (recovery period) assumption for a given asset category remains unchanged (at L) – implying the same basic depreciation rate (1/L) under the previous (e.g. straight-line) system and the new (e.g. declining-balance) system – a one-time percentage increase in the underpreciated capital stock balance would be required (with that percentage determined with reference to the present value of capital cost allowances streams under both methods).

25. As noted above, the straight-line method depreciates capital at a constant rate of (1/L), where L is the asset's assigned recovery period in years. With basic (100%) declining-balance, the depreciation rate is (1/L), applied to a declining-balance base. Under double-declining balance, the depreciation rate is (2/L), applied to a (double) declining-balance base. Other multiples (e.g. 150%, 300%) are possible. The higher the scalar coefficient, the more 'front-end loaded' is the system.

26. See Jorgenson, Gravelle (1999) and Brazell and Mackie III.

27. In other words, assuming a profitable/taxable firm, the present value of depreciation allowances on a given investment (say of one currency unit in an asset with an assigned recovery period of L years) is lower under a standard (100%) declining-balance method, where claims in each year including the investment year and thereafter, are (1/L)x(undepreciated cost), as compared with (1/L) in each year over L years.

28. In general, scalars coefficients (or simply 'scalars') applied to asset categories depreciated on a declining-balance basis should be set with the aim of not imparting distortions in investor choice across different depreciable asset categories. To take an example, assume assets in category A have an average productive life (basic recovery period) of 5 years, with a scalar of 2 to provide what is believed to be true (economic) depreciation, giving an effective rate of aA=2x(1/L)=20%. Category B assets have an average productive life (basic recovery period) of 10 years, with a scalar of 1.5 to provide what is believed to be true (economic) depreciation, giving an effective rate of aB =1.5x(1/L)=15%. In general, the present value of depreciation allowances provided by a declining-balance system at rate aj is given by aj/(R+aj), assuming a taxable firm, where R is the nominal rate used to discount future allowances. Assume that a decision is taken to accelerate depreciation, and an additional scalar sA is applied to aA, giving a new (accelerated) depreciation rate for category A assets aA*=sA·aA. So as to not distort investor choice between category A and category B assets, the additional scalar for category B assets sB should be chosen so as to keep the relative present values of depreciation allowances on new investment in category A and B assets constant at c=(aA/(R+aA))/(aB/(R+aB)). In other words, sB should be chosen such that the following holds c=(aA*/(R+aA*))/(sB·aB/(R+sB·aB)).

29. Separate accounts may be desirable, however, during a transition period from a non-accelerated to an accelerated system. In order to target tax incentive relief to new investment (i.e. to avoid giving tax relief in respect of physical capital already installed), policy-makers may wish to apply accelerated depreciation only to capital acquired after a given implementation date. This would involve keeping one set of accounts for previously acquired capital, and a new set of depreciation accounts for new capital. Over time however, the old accounts would expire (remaining unclaimed depreciation allowances would be claimed), leaving one set of post-implementation accounts.

30. As noted above, in general, scalar coefficients for various depreciable asset categories should be set with the objective of not distorting investment decisions over different asset types. Thus, when ratcheting up effective depreciation rates, the scalars that would provide for neutral tax treatment (across asset types) should be increased by the same percentage (see also the preceding footnote).

31. n Germany, an unlimited and indefinite loss carryforward is provided for losses in excess of DEM 1 million. A loss carryover is denied if a) more than 50% of the shares (of the loss) company is transferred to another company and b) the business of the company is continued with more than 50% new business assets. Similarly, in Sweden and the U.K., restrictions on loss carryover rules apply where there has been a substantial change in the ownership of the company.

32. The example assumes, for simplicity, a single stock of capital with a productive life of 10 years, and a 10 year recovery period in case A. Accelerated depreciation in case B provides for 500% declining-balance and thus an effective declining-balance depreciation rate of (5/1)x(1/10)=50%.

33. See Ng, describing the provisions recently introduced in Singapore.

34. Various exemptions are granted in China, but those seem likely to disappear with that country's entry into the WTO.

35. Nee and Powell. The announcement of the decision was followed by a severe drop in the level of FDI in China, which seems to have induced the government to partly restore the exemption.

36. This was done in Russia after reports of abuses. There have been similar reports of abuse in Ukraine. See «Ukraine to Scrap Tax Breaks for Foreign Ventures», 20 *Tax Notes International* 739 (2000).

37. There should, however, be a further caution. Countries that have introduced a large variety of incentives, each pursuing different objectives that are sometimes overlapping or conflicting, rarely succeed in achieving any of the desired objectives.

Chapter 3.

PREFERENTIAL TAX ZONES

A. Introduction to "Zones"

Special "zones",[1] established with the primary aim of attracting investment, come in a variety of forms, serve a number of distinct purposes, and are referred to by a variety of names, among which the most commonly encountered are *customs zone*, *duty-free zone*, *foreign trade zone*, *free trade zone*, *free port*, *export processing zone*, *international trade zone*, *free economic zone*, *enterprise zone and special economic zone*, plus local variants, such as the Latin American *maquiladora*.

At least 800 such zones exist around the world, in more than 100 different countries, employing five million or more workers, and participating substantially in the volume of world trade.[2] One feature which they almost all have in common is that customs duty arrangements and/or special tax provisions are applicable to qualifying zone companies that are not generally available outside the zone.[3] Thus preferential tax zones provide (various types of) targeted tax relief typically to geographically limited (often fenced-in) areas, often with further targeting criteria.

A basic distinction can be drawn between *duty-free zones* and *special economic zones*, as they will be called here. The essential characteristic of the various types of duty-free zone is that they provide exemption from import and export duties on the trans-shipment of goods. The essential characteristic of special economic zones is that they offer exemptions from or reductions in other taxes that are not generally available in areas outside the zone. However, in practice, it is not uncommon for enterprises located in duty free zones to receive exemptions from other taxes as well as customs duties. And often customs duty exemptions are granted in special economic zones. Hence, there are some zones which may be difficult to classify into one or other of the two categories, or which belong to both categories. Furthermore, in some cases, a duty-free zone may be located within a special economic zone. For example, China's largest duty-free zone is situated in Shanghai's Pudong New Area, and a (duty-free) export-processing zone was recently established inside the largest special economic zone (in terms of volume of production), Shenzhen SEZ.

As elaborated in the country chapters, all SEE countries offer zone incentives, although the design features vary across countries. Given their importance, this chapter focuses exclusively on this type of targeted incentive measure.

B. Duty-Free Zones

Although a duty-free zone forms part of the physical (geographical) territory of the country in which it is established, it normally does not form part of that country's territory for customs purposes.[4] In effect, the zone is treated as if it were the territory of another country: goods entering the zone from abroad are not regarded as being imported into the country in which the zone is located, while goods entering the country from the zone are regarded as being imported. Conversely, goods are considered exported when they enter the zone from the home country, but not when they are transported from the zone to some other country, since they are already outside the customs area.

Duty-free zones may be further classified into *free trade zones* and *manufacturing* or *processing zones*, according to the activities permitted or undertaken in the zone.

1. *Free Trade Zones*

Free trade zones, and "free ports" in particular, which have a long history, serve primarily to facilitate entrepot trade and the trans-shipment of goods.[5] Goods are unloaded and reloaded into fresh consignments, and sometimes re-packaged or re-labelled. A modern variant on the classic free port is the "hub" – established adjacent to a suitable airport by one or more of the large international air carriers to serve as a trans-shipment centre for an entire region. Another variation is the "distribution centre", providing storage or warehousing facilities for a large manufacturer, from which deliveries are made to customers in different countries.

Zones of this nature are normally quite small,[6] and provide accommodation for a number of enterprises, although some zones have a single tenant. They are securely fenced and are under special customs supervision. Customs duties (and VAT) are not charged on goods entering the zone from another country or on goods leaving the zone and destined for other countries. Where the trade of the zone is entirely international, i.e. no goods enter the zone from the host country, or vice versa, the customs and VAT arrangements are extremely simple: no duty or (sales) tax is imposed at all, because there is no domestic consumption. All that is required is adequate supervision to prevent goods being smuggled from the zone into the host country.

However, that will rarely be the case. Usually, some of the goods introduced into the zone will subsequently be sold on the domestic market, and the zone may also be used as a transit stage for exports from the host country. For example, in the "hub" type of operation, goods will enter the zone (located in country A) from countries X and Y, for onward shipment to purchasers in countries B and C, *and* in country A. In some cases, goods will also enter the zone from country A for onward shipment to other countries.

Consequently, it is necessary to monitor goods entering the host country from the zone, and goods entering the zone from the host country. Goods entering the host country will be treated as imports, and be subject to customs duties[7] and to VAT: goods leaving the host country will be treated as exports, zero-rated for VAT, and entitled to customs duty drawback where appropriate.

Arrangements of this type should perhaps not be considered as tax "incentives", since they are broadly consistent with the normal GATT rules on taxation in international trade. Customs duties and VAT are taxes on domestic consumption, and therefore should be and are imposed on goods entering the domestic market from the zone, but not on goods that are exported through the zone, or on goods that are merely in transit through the zone between two other countries. This assumes that no consumption takes place in the zone. In practice, there will always be some consumption – of fuel, workers' meals, etc. but normally this will be minimal, since it is not usual for the zones to have permanent residents.[8]

The principal advantages for zone investors are:

- Simplified administration.
- A cash-flow benefit, since they are not required to pay tax and duty on entry of goods into the zone and then to apply for a refund on exit.
- An exemption from customs duty on imported equipment used in the zone.

Additionally, zone enterprises may enjoy other tax benefits, such as tax holidays, although these are more commonly given only in manufacturing and processing zones.

2. *Manufacturing and Processing Zones*

The evolution of free trade zones into manufacturing and processing zones is a relatively recent phenomenon, usually traced back to the establishment of the Shannon Free Zone in Ireland, in the early 1960s.[9] Typically, such zones take the form of an "export-processing zone" (EPZ), which may be defined as

«[an] administratively and sometimes geographically defined area, enjoying special status allowing for the free import of equipment and other materials to be used in the manufacture of goods earmarked for export.” [10]

Components, equipment and raw materials are imported into an EPZ free of duty and VAT, where they are used to assemble, process or manufacture goods in the zone for export. The typical EPZ tends to be approximately the same area as a free trade zone, or a little larger, since manufacturing and processing operations tend to require more space.[11] Like free trade zones, it will normally have a number of occupants: however, some countries (for example, Hungary and Malaysia) permit single investors to establish their own zone: these are sometimes called “bonded factories” or “licensed manufacturing warehouses”.

In some EPZs enterprises are required to export all their finished products (i.e. are not allowed to sell their products in the host country). In other cases domestic sales require special permission, or the enterprise must export a stipulated proportion of its total production. For example:

- Enterprises in the recently established free trade zones in Cuba may sell up to 25 per cent of their total production in the domestic market.
- Those established in Fiji’s tax free zones must export a minimum 80 per cent of their production (i.e. sell a maximum of 20% in the domestic market).
- Malaysia’s free industrial zone firms must normally export their total production.

Other countries impose no restriction upon domestic sales from their duty-free zones, simply treating such sales as imports from the zone into the domestic market, subject to VAT and duty in the same way as other imports, except that the proportion of the value-added in the zone is often exempted from duty.

Exemptions provided from customs duties and VAT on imported components and materials are similar to those given in free trade zones. However, the exemption from customs duty on machinery and other equipment tends to be more important in EPZs, since more equipment is typically used in manufacture or processing than in simple trans-shipment.

Not all manufacturing and processing zones are EPZs. Some of the foreign trade zones of the United States might more properly be described as “import processing zones”, since their primary use is to assemble or process components and materials imported from abroad for eventual sale in the domestic market. One advantage is that payment of duty is delayed until delivery into the internal market. The principal advantage, however, seems to lie in the fact that the rates of duty on finished products in the U.S. are sometimes lower than those on materials or components: finished products assembled in the zones are subject to the lower rate of duty when released into the internal market.

Export processing zone status often (but not always) provide relief from other taxes, such as profits tax. For example, enterprises in Turkey’s free trade zones enjoy complete exemption from corporate income tax. More commonly, tax holidays are granted for a limited period – for example, India grants tax holidays for up to 10 years for manufacturing enterprises established in its free trade zones. By contrast, enterprises in Hungary’s duty-free zones (which are essentially export-processing zones) and in Mexico’s maquiladora receive no extra tax advantages other than those that may be available under the general tax legislation. Many zones also offer non-fiscal incentives, such as subsidised infrastructure, low rents and cheap electricity. However, special tax privileges granted in export-processing zones may be considered an export subsidy and be prohibited under WTO rules: this issue is discussed further in Chapter 6.

C. Special Economic Zones

The term “special economic zone” (SEZ) is employed here to describe designated areas or regions of a country in which special tax exemptions or reduced rates apply, generally in relation to the taxation of profits, that are not granted elsewhere in the country. An alternative term, “free economic zone”, is widely used in transition countries.

Special economic zones vary greatly in size, and in the activities carried on by their residents. For example:

- The Polish SEZs are relatively small in area (mostly about 400 - 600 hectares) and are fenced off from the surrounding country. Physically, they resemble export-processing zones, although they do not enjoy customs duty exemption. (In some of the zones there is a separate bonded sector.) They might best be described as industrial parks in which investors enjoy special tax privileges.
- China's special economic zones are considerably larger in area. The largest of the zones, in terms of production, Shenzhen SEZ, covers an area of 327 sq.km., is home to some 20,000 enterprises, and annually exports goods to the value of US $25 billion. One SEZ, Hainan, occupies an entire island province of 34,000 sq.km., with a population exceeding seven million.
- Some of Russia's zones are also very large. The Nakhodka FEZ, on the Pacific coast, covers an area of 4,579 sq.km. The Kaliningrad FEZ embraces the entire enclave, and covers over 15,000 sq.km.

In the case of the largest zones, such as Hainan and Kaliningrad, the difference between a special economic "zone" and a designated region in which investors receive tax advantages is not always very clear, especially as each constitutes a separate province or oblast in its own right.

The common feature is that investors in these "zones" or regions enjoy special profit tax advantages that are not available elsewhere in the country. In the Chinese zones, for example, the normal rate of profits tax is reduced from 30 per cent to either 15 or 24 per cent, depending upon the type of zone. Enterprises in Poland's zones receive a ten-year exemption from profits tax, with a further period of up to ten years at half rate.

Elsewhere, investors in the British "enterprise zones" are eligible for accelerated depreciation and for property tax exemptions, and firms operating in the French urban enterprise zones benefit from exemption from the *taxe professionelle*. As noted above, zone enterprises sometimes also enjoy exemptions from customs duties.

D. Preferential Tax Zones – An Evaluation

The worldwide prevalence of duty-free zones and special economic zones, the volume of investment they have attracted, and the number of jobs they have created would seem to attest to their success as a form of investment incentive. An assessment of the actual results, however, is rather more complex.

One factor to be taken into consideration is that, unlike simple tax incentives, zones have a "real" cost as well as a budgetary cost. The land must be made available, often buildings are provided, utilities are connected, access roads, docks or airstrips are constructed, and so on. These costs vary considerably and can amount to as much as $50 million per sq.km. Sometimes the zone is a well developed industrial estate, all ready to accommodate tenants. In other cases it is simply a vacant piece of land, with roads and buildings existing only on a planner's map. Some "zones" are really no more than regions designated to have special tax privileges. Occasionally, a suitable ready-made zone already exists. For example, in the Central and Eastern European countries, abandoned Warsaw Pact military facilities have provided suitable facilities for an industrial park.[12] Another way of reducing the cost of establishing a zone is simply to permit a foreign investor to do so and assume the costs, allowing the investor to recoup its expenses in the rents and management fees charged to other tenants.[13]

In attempting to evaluate the performance of preferential tax zones as a form of investment incentive, it is convenient to adopt again the distinction between duty-free zones and special economic zones.

1. *Duty-Free Zones*

An advantage of duty-free zones, particularly free trade zones and to a lesser extent processing zones, is that a high proportion of the investment that they attract may be incremental investment. An international carrier that establishes a "hub", or a foreign exporter that sets up a regional distribution centre, is most

unlikely to have done so without the existence of a duty-free zone (or of efficient customs procedures that achieve the same result). Similarly, where a manufacturer establishes a garment factory or a microprocessor plant, the investment may be incremental. Further, the cost of a duty-free zone, in terms of revenue foregone, is negligible provided the customs system operates as it should, and provided other tax incentives are not given. (There remain, of course, the "real" costs of providing the land and infrastructure, which may or may not be recovered in the form of rental payments.)

In the case of free trade zones, where the principal activity is trans-shipment, it is probably unnecessary to offer any additional tax incentives. A main reason for this is that they are not needed, as the taxable profits that can be allocated to those activities (storage, repackaging, etc.) will normally be relatively small, and the location of the zone, its infrastructure, and the quality of its administration, will count far more to potential investors than any exemption from profits tax.

By contrast, most countries that have established export-processing zones offer generous tax incentives to their occupants. One rationale for doing so is that the cost in terms of foregone revenues (on existing activity) will be low to the extent that investment in EPZs is incremental. Arguably, most activity under an EPZ will be incremental as there are so many zones to choose from, around the world, that a zone which does not offer generous tax holidays and other benefits simply cannot compete. That may be so for some types of investment – for example, garment manufacture. In other cases, the host country may have other advantages to offer, such as a skilled labour force or a particularly favourable location. For example, the Mexican *maquiladora* can offer Mexican wages, a location on the U.S. border with excellent communications to major population centres, plus access to U.S. markets under NAFTA. However, in such cases where location-specific advantages (enabling conditions) exist, one must question whether tax incentives generate incremental investment, or simply provide windfall gains.

In deciding whether to establish one or more duty-free zones, the following issues should be considered:

- Is the establishment of a zone more appropriate than the adoption of customs procedures for duty deferral and drawback?[14]
- What types of activity are intended to be carried on in the zone?
- Are additional tax incentives warranted, and in what circumstances?

In considering the second question, it seems obvious that duty-free zones are suitable only for those firms that are engaged in trans-shipment or those that export the bulk of their production. However, the fact that a firm intends to export all or most of its production does not necessarily mean that a duty-free zone will provide the most suitable location for all production activities. That depends, to a large extent, on the required inputs and the costs of acquiring or accessing them. Where the activity in question is principally that of assembling imported components (as it is in much of the electronics and garments sectors), then an EPZ does offer a number of advantages. But where the activity involves substantial use of locally sourced materials (such as food or mineral processing), an EPZ confers few, if any advantages, and may even prove a major inconvenience since all domestic inputs will be subject to customs control. Provided VAT refunds and customs duty drawbacks are made promptly, and especially if there is a customs duty exemption for imported production machinery, an export-oriented producer may prefer to be established outside the zone.[15]

2. *Special Economic Zones*

The reasons for establishing special economic zones vary from country to country. In China, whose SEZs have provided a model for many other countries, one of the initial reasons seems to have been to allow an experiment with a "socialist market economy" to be insulated from the remainder of the country. That is why the first four SEZs were located in coastal "enclaves". (Another reason was the proximity of those enclaves to Hong Kong, Macao, and Chinese-Taipei) Only when the experiment appeared to be working satisfactorily – both from an economic and a political perspective – were further special zones established. Sometimes, it is difficult to discern any valid reason for the existence of a SEZ. However, to generalise, there would seem to be two principal objectives:

- To provide an attractive and secure environment for investors, and/or
- To attract investment to a particular region or location.

The first objective is understandable in countries whose market economy is relatively undeveloped, and costs and uncertainties associated with government bureaucracy and the protection of property rights pose significant impediments. In order to attract investors, a host country may feel compelled to provide a secure, fenced enclave, with good communications and infrastructure and a competent management, often offering "one-stop" licensing services. The zone is thus a *more* attractive location for investment than the surrounding parts of the country. That being the case, it is difficult to see the justification for granting tax incentives that are *more* favourable than those available elsewhere in the country (which is not to say that incentives should never be granted in SEZs, but rather that this type of SEZ should not provide incentives that are more generous than would be available outside the zone).

The second type of SEZ is established in order to attract investment to a disadvantaged region of the country, and is perceived as an instrument of regional development policy. Here, the rationale for the creation of a special environment for investment and for preferential tax treatment may be to compensate for the disadvantage of the location. What is difficult to understand is why the tax preference should be granted to investment in a particular designated zone, but not elsewhere in the region where the zone is situated.[16] For example, several of the Polish SEZs are located in less developed regions or regions of high unemployment. They provide a secure and attractive environment for investment, and they confer substantial tax benefits. But other enterprises in the same disadvantaged region, but outside the perimeter fence, do not receive those benefits.

NOTES

1. Parts of this chapter are based on Easson (1998b).

2. The World Export Processing Zone Association listed (in June 1996) over 500 export-processing zones alone: Bolin and Haywood. By 1998 the list had grown to 839: Bolin.

3. Many countries have also established special zones – called *business parks*, *industrial parks*, or *science parks* – that while not offering special tax advantages, offer non-fiscal incentives to invest such as subsidised infrastructure. Since these do not provide tax relief, they are not considered in this study.

4. That is so for purposes of customs duty (and often also for VAT purposes); imports into, and exports from, the zone are usually counted for statistical purposes (e.g. in computing trade balances). European Community rules are somewhat different from those described above, in that free zones and free warehouses are part of the customs territory of the Community, although payment of duty is suspended under prescribed conditions; see Terra at p.852.

5. Ancient Carthage was reputedly a free port. From the fourteenth century on, the major Italian trading city-states, including Genoa and Venice, established chains of free ports throughout the Mediterranean, whilst further north the Hanseatic League cities were doing the same in the Baltic and North Seas. Gibraltar was established as a free port in 1704, and the nineteenth century saw the creation of "treaty ports" such as Hong Kong and Shanghai in China.

6. A typical area would be 100 – 200 ha.

7. As customs duties are likely to vary according to the country of origin of the goods, it will also be necessary to verify the original country from which the goods entered the zone.

8. The situation is different, and much more complex, when an inhabited area is given duty-free status – e.g. the Kaliningrad region of Russia.

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9. Similar zones were established in the Dominican Republic around the same time.

10. Basile and Germides at p.20.

11. China's largest EPZ, situated within the Shenzhen SEZ, covers an area of 3 sq.km.

12. E.g. SSE Mielec, the first special economic zone in Poland. The Clark SEZ, in the Philippines, occupying the site of a former US military base, is another example.

13. E.g. the Korean industrial park established within the Nakhodka FEZ.

14. These need not be alternatives. Duty free zones may still have a useful function even if satisfactory customs procedures exist. However, some countries may find that it is only by establishing a distinct zone that proper supervision can be exercised.

15. That may depend on whether additional tax privileges are conferred on EPZ firms. It should be noted that approximately 75% of enterprises in China's Shenzhen SEZ are engaged in export processing, without being located in a separate EPZ.

16. Some SEZs, for example Hainan island or the Kaliningrad region, are actually entire regions, so the objection does not apply in those cases.

Chapter 4

TARGETING TAX INCENTIVES

A. The Nature of Targeting

The key characteristic that distinguishes tax incentives from general tax measures is the fact that they are selective in their application – that is, only certain types of investment are eligible to receive the preferential treatment. Incentives may be broadly targeted – for example, all new investment, foreign or domestic – or may be very narrowly targeted – for example, new foreign investment in the motor industry exceeding $50 million.[1]

Targeting may hold out certain attractions (elaborated below), depending on the nature or type of targeting, and the incentive mechanism used. One type of targeting limits special tax relief to certain (geographical) locations, for example to designated "zones", as discussed in the previous chapter. Many other possibilities for targeting exist, with the main types summarised below. The final section of this chapter considers certain disadvantages with targeting, including possibly significant scope for corrupt administrative practices in exercising targeting provisions. A final consideration is that certain types of targeting may be viewed as distorting to fair competition, and subject to peer review.

B. The Attraction of Targeting

As noted, the defining characteristic of targeting is that it limits tax relief to only certain types of investment. Investment types can be differentiated along a number of dimensions, as reviewed below. In general, however, the targeting of incentives serves two main purposes:

- *Targeting identifies and supports the types of investment that the potential host government particularly seeks to support or attract.*

The central policy justification for targeting tax relief is to address so-called instances of "market failure" – that is, instances where the operation of private markets is believed to fail in yielding a socially optimal level of investment. An inefficiently low level of FDI may arise where there are positive "externalities" or spillover effects that are not incorporated into private investment decisions of investors (e.g. possible beneficial effects on host countries generated by training).

In practice, the impetus to provide targeted tax relief is to help the host country compete with other jurisdictions in attracting capital, and jobs (and to limit revenue losses in doing so). The targeting of particular types of investment raises the question of whether some types of FDI should be considered to be more desirable or beneficial compared with others. Should governments seek to attract, and target their incentives at, particular types of investments and not others, or should it be left to the market to decide? On this question, one may be sceptical about the ability of politicians to decide what is good for their countries and to "pick winners" however, it seems clear that there are some types of FDI that, if they are not be excluded altogether, certainly merit no encouragement in the form of tax benefits.

- *Targeting reduces the cost of providing special tax relief to the extent that it reduces the number of taxpayers that benefit.*

If possible, host countries would generally prefer to provide incentives only to incremental investment to avoid revenue losses on investments that would have occurred in the absence of incentive relief. And

although it is virtually impossible to restrict incentives only to those enterprises that would not otherwise have invested, certain types of targeting could be expected to reduce the number of instances where tax relief is provided giving windfall gains to "free-riders". For example, where incentives are intended to induce enterprises to invest in one country rather than in another, or in one part of a country rather than in some other part, countries may attempt to restrict the benefits to those enterprises that are relatively mobile and enjoy the freedom to choose their locations. As noted in the first two chapters, the more geographically mobile an investment is, the more likely it is to be influenced by tax considerations. Financial centres, and garment and microchip manufacturers tend to be highly mobile, and are frequently offered special incentives. By contrast, retail establishments have no choice but to locate where their customers are. It is probably for that reason, rather than any value judgement as to the relative importance of trade versus production, that they are rarely offered incentives.

C. Types of Targeting

Tax relief may be targeted in a variety of ways and combinations, along one or more of the following dimensions:

- By type of investor (foreign vs. domestic; new vs. existing).
- By scale of investment (large vs. small).
- By type of business activity or sector (manufacturing, R&D).
- By type of factor input (tangible capital, intangible capital, labour, energy, materials).
- By geographical location (depressed regions, designated zones).
- By type of market [domestic and foreign, versus foreign (export)].

Other (less common) targeting criteria may also be found (e.g., source of finance). Moreover, various possibilities exist within and across these categories. For example, tax relief may be targeted at specific types of tangible capital (e.g. advanced technology and equipment), used in specific sectors and perhaps in specific locations. The following reviews a number of the more common targeting provisions found in SEE tax systems and elsewhere.

In addressing targeting approaches, an important distinction can be made between incentive mechanisms that target relief by subsidising the cost of acquiring capital (or hiring or purchasing other factors of production, and incentive mechanisms that provide relief from business profit derived from those (and possibly other) factors of production. We refer to the first category of incentives as expenditure-based, and the second as profit-based. For example, in targeting intangible capital, one could use an expenditure-based incentive that lowers the cost of acquiring that capital, or alternatively one could use a profit-based incentive in an attempt to target tax relief to the profit derived from the use of that capital. An example of the former would be an investment tax allowance or credit, while an example of the latter would be a partial or full profit exemption (as under a tax holiday).

1. *Foreign or Domestic Investment?*

Tax incentives for FDI are, obviously, intended to attract *foreign* investment. Their cost may be reduced if they are restricted to foreign investment, rather than being made equally available to domestic investors. Outside the more developed countries, it is often the case that domestic investors have little or no real opportunity to go elsewhere, and therefore do not need special incentives to encourage them to invest at home. To restrict incentives to foreign investors, or to investment with substantial foreign participation,[2] may be appropriate in the early stages of transition to a market economy, when most domestic enterprises remain state-owned: otherwise it would seem to be undesirable. Such a restriction may be objected to on the following grounds:

- *Discrimination in favour of foreign investors distorts competition.*

In addition to distorting the conditions of competition between foreign and domestically-owned firms, it may restrict the growth of domestic enterprises, or even prevent the development of a domestic sector.

It is also likely to cause resentment, or worse. In late 2000, the Slovak Government was forced to modify plans to grant new ten-year tax holidays to foreign investors, following opposition protests that domestic companies would not be able to compete. Earlier in the same year, there were reports from Zambia that there had been a dramatic increase in smuggling, following the grant of generous tax breaks to a foreign-owned retailing company: local traders were competing by purchasing cheap goods smuggled into the country.[3]

- *Discrimination in favour of foreign investors often results in "round-tripping."*

"Round-tripping" occurs when domestic investment capital leaves the country to return disguised as foreign investment. (It is sometimes described as "fictive" foreign investment.) Round-tripping is usually done in order to take advantage of tax incentives or of other privileges that are given only to foreign investors. It seems to be a common phenomenon in China, and partly accounts for the very high level of FDI in that country, as well as for the high levels of both inward and outward investment in Hong Kong. Typically, money leaves China (presumably illegally) and returns in the form of "foreign" investment from Hong Kong, often made by companies incorporated in the British Virgin Islands.[4] An OECD study of tax incentives in transition economies found evidence of similar practices in several countries,[5] and the rather strange fact that an unusually large proportion of "foreign" investment in Russia comes from Cyprus suggests that a considerable amount of round-tripping is occurring.

Occasionally, there is discrimination *against* foreign investors, although this now seems to be rare. In China there are a few instances of foreign-invested enterprises receiving less favourable treatment than corresponding domestic firms, although this form of discrimination is due to be eliminated in order to facilitate that country's entry into the WTO.[6] Another limitation on the granting of incentives is that they are sometimes restricted to companies (or other legal entities) established in the host country. Companies with foreign participation are eligible – and are often the main intended beneficiaries – but not the branches of non-resident enterprises. However, most foreign investors will in any event usually prefer to operate through a local subsidiary, so such a restriction is unlikely to have much of an adverse effect on investment decisions.

2. *New Investors*

The most common form of investment incentive, at least in the past, is the tax holiday, given to new investors commencing from the date of incorporation or registration, or from some later date such as that on which business activities commence. By its nature, such an incentive is targeted at new investors. Perhaps the rationale (if there is one) is that once a new investor has been "captured", its subsequent investment decisions will be made solely according to its business needs and will not be influenced, or at any rate will be less influenced, by tax considerations. However, this tends to ignore the fact that a substantial proportion of FDI takes the form of contributing additional capital to existing operations, or of reinvesting the profits from those operations. One would have thought that capital invested in those ways would be no less valuable and desirable than capital invested initially by new investors.

In practice, restricting incentives to new investors tends to be ineffective and may be counterproductive:

- An existing investor, planning to expand its operations, will often incorporate a new subsidiary to undertake those operations, with the subsidiary qualifying for a new tax holiday.[7]
- A tax holiday may be prolonged or multiplied by one investor transferring existing business assets to another company that has been formed in order to carry on the same business and to qualify for a new tax holiday. In such a case, the tax holiday is, in effect, given twice for the same investment.[8]

3. *Large Investors*

Since the principal purpose of offering tax incentives is to attract more FDI, there is, not surprisingly, a view taken by some that "the more, the better". This view is often reflected in provisions that restrict the

granting of incentives to "large" investments, i.e. those exceeding a stipulated amount. The amount varies greatly from country to country and is sometimes further restricted to particular types of investment. To give a few recent examples (in approximate amounts, converted to US $):

- Uzbekistan: $300,000.
- Slovak Republic: $5m.
- Latvia: $16m.
- Korea: $100m.
- Turkey: $250m.
- Indonesia: $700m.

Often, the imposition of a dollar threshold effectively limits the incentive to foreign investors, without formally discriminating against domestic enterprises, because no domestic investors possess sufficient capital to meet the qualifying threshold. In some cases, the amount is even fixed with a particular investment in mind.[9] Other countries have dropped all pretence of applying objective criteria and simply negotiate specially tailored packages with individual large investors.

In principle, it seems difficult to justify a qualification based on a particular threshold. One would have thought that two investments, each of $3m, would be more beneficial to the host country than a single investment of $5m. Only in very marginal cases is an investor likely to increase the size of its planned investment in order to obtain a tax privilege: when it does so, the additional investment is likely to be less than the extra cost, to the host country, of the incentive that is obtained as a result. What is more likely is that the investor will arrange the manner in which the investment is financed in order to qualify, or that the amount will simply be inflated by overvaluation of the assets contributed. For example, intellectual property will be assigned to the new firm, as part of the contribution to capital, rather than being licensed to it. Overvaluation is common and almost seems to be encouraged by some foreign investment agencies, since it helps the agency to meet its performance targets. In any event, valuation may be a difficult exercise and imposes a substantial administrative burden.

One reason for linking incentives to the size of the investment may be that the most common form of tax incentive is the tax holiday. By their nature, tax holidays are not related to the amount invested (except in the sense that the larger the investment, the greater the anticipated profit – and consequently the tax saved), and the imposition of a qualifying threshold may be seen as a means of establishing such a relationship. If so, it is a crude instrument for doing so. If the size of the investment is considered important, then it is preferable to relate the incentive directly to the amount invested (for example, by granting investment allowances or investment tax credits).

4. *Sectoral Targeting*

The granting of preferential tax treatment to certain sectors of the economy, or to certain activities, has been a common practice ever since taxes were first introduced. For years, many countries have granted preferences to agricultural activities, often taxing (or not taxing) income earned from agriculture in an entirely different manner than other forms of income.[10] Manufacturing activities are also commonly targeted. More recently, "pioneer" industries and R&D activities have been targeted.

a) Manufacturing

It is not uncommon for investment incentives to be restricted to manufacturing activities, or for those activities to receive preferential treatment. For example:

- Ireland's reduced tax rate originally applied only to manufacturing, plus a few other special activities, deemed to fall under the "manufacturing" definitions.
- China's tax concessions are normally given only for "production activities", i.e. for manufacturing and processing, in certain listed industries.

- Although tax incentives in the Czech Republic are granted on an essentially discretionary basis, in practice incentives had been restricted to manufacturing activities (prior to 2001).

This may reflect a perception that manufacturing is somehow more valuable than the provision of services, perhaps because of its employment creating potential, or a view that services (with some exceptions) tend to be more market-oriented and therefore less likely to be influenced by tax considerations.

b) "Pioneer" Industries

A somewhat more sophisticated approach is that where a country restricts special investment incentives to certain broadly listed activities or sectors of the economy. In Malaysia and in Singapore, for example, one of the most important categories of tax incentives is that granted to "pioneer" enterprises: generally, to be accorded pioneer status an enterprise must manufacture products of which there is not already an adequate domestic supply, or be engaged in certain other listed activities that are not being performed by domestic firms and that are considered to be especially beneficial to the host country. The pioneer system, which is also used in countries such as Nigeria, Philippines and Vietnam, usually combines elements of both automatic and a discretionary system. To qualify for the incentive, an investment must fall within a listed category and satisfy certain objective criteria, but must also be certified by the designated authority as being in the national interest. The experience of Singapore, and perhaps also Malaysia, seems to demonstrate that it is possible for governments to be fairly successful in "picking winners", but other countries that have tried the same approach have been less successful. One problem is that the list of pioneer sectors tends to grow, and is often expanded to accommodate a particular investment that is being proposed.

c) Specific Sectors

In recent years, the practice has grown of introducing selective incentives narrowly targeted at particular types of investment, especially technologically advanced industries. For example, and looking only at tax incentives that have been introduced since the beginning of 2000:

- Incentives for the electronics industry, and activities such as wafer manufacture, have been introduced in China, Indonesia, Korea, Malaysia and Thailand.
- Software development and information technology have been encouraged by new incentives in China, India, Pakistan, Philippines and Singapore.
- Film production is encouraged in Australia, Canada and Ireland, among others.[11]
- Special incentives are given for infrastructure development in Egypt, India, Pakistan and Vietnam.
- Tourism has been given new tax incentives in Bangladesh, Malaysia and Venezuela.[12]
- The prevalence of incentives for financial centres, MNE headquarters companies and other "offshore" activities was noted in Chapter 1: recent additions to the list of countries offering special low-tax or tax-free regimes include China, Cyprus, Mauritius and Chinese Taipei.

Sectoral targeting, where successful, offers certain advantages. It restricts the benefits of the incentives to those types of investment that are considered to be most desirable, and it also makes it possible to concentrate on those sectors that are most likely to be influenced by tax considerations. However, there are inevitably definitional problems, and difficult situations arise where an investor is engaged in a variety of activities, only some of which fall within the privileged category.

5. *Technology Transfer*

A major reason why developing countries seek to attract FDI is to gain access to modern technologies and know-how, and tax incentives designed to promote technology transfer are common. Many critics of the use of tax incentives accept that there may be a case for incentives to promote activities such as research and development, if only as a way of countering market imperfections, although experience with such incentives tends to have been rather unsatisfactory.[13]

Countries attempt to attract technologically-advanced investment in a number of ways:

- By *targeting incentives at technologically advanced sectors*.

Targeting incentives at technologically-advanced sectors, such as microchip production or software development, has already been considered. It is a somewhat limited approach, since many "conventional" industries also use advanced technologies, the introduction of which could be equally beneficial to the host country. The evidence also seems to indicate that technology *transfer* is *less* likely to occur in the hi-tech sector, since those firms tend to guard their secrets most carefully. A stronger reason for targeting the hi-tech sector may be that it tends to be highly mobile and more influenced by tax considerations.

- By *providing incentives for the acquisition of technologically advanced equipment*.

In China, an enterprise using advanced technology and equipment is eligible for an additional tax holiday of three years, at half the normal CIT rate, after the expiry of any other tax holiday for which it is eligible. This incentive is not restricted to any particular type of activity. The enterprise must introduce newly developed products, must have a technology transfer agreement in its joint venture contract, and the imported machinery and equipment must be superior to Chinese produced machinery in terms of performance and efficiency. An obvious problem with this type of approach is that it may induce the investor to adopt inappropriate technology in order to secure tax privileges. It also requires a determination of whether the technology really is "advanced" – something which tax authorities are rarely equipped to judge. A more common alternative approach is to encourage the acquisition of such equipment by granting special investment allowances or accelerated depreciation, and/or by granting import duty exemptions.

- By *providing incentives for carrying out* R&D *activities*

Incentives for carrying out R&D activities are common in both developed and developing countries. Malaysia provides a fairly typical example. A five-year tax holiday is granted for approved research companies or institutions established to undertake research and development for a particular industry. In addition, a double deduction of research expenditure may be claimed in some circumstances. Again, there are problems with these types of incentive – in particular determining what constitutes "research and development".[14]

6. Export Promotion

Another important objective of attracting FDI is to promote exports, and generally to improve the host country's foreign exchange position. The experience of many developing countries is that export promotion, and the attraction of export-oriented investment, is the quickest and most successful route to economic growth. It is therefore hardly surprising that competition to attract such investment is especially fierce, and investment incentives are frequently targeted at export-oriented production. Additionally, as noted in Chapter 1, incentives targeted specifically at export-oriented investment tend to be more effective than most other forms of tax incentive, in particular where there is a high degree of mobility of such investment.

Various types of tax incentive are employed to promote exports. For example:

- In China, firms that export more than 70 per cent of their total production enjoy extended tax holidays.
- In Singapore and Sri Lanka, profits attributable to export sales are exempt from tax.
- In Malaysia, export performance is one of the factors that enables an enterprise to qualify for pioneer status, and double deduction is allowed for expenditures related to export promotion.
- Throughout much of the world, export-processing zones have been established, in which preferential tax rates apply (as discussed in Chapter 3).

One important factor to be considered is that such incentives may constitute an export subsidy and thus be contrary to WTO rules; this aspect is discussed in Chapter 6.

7. Employment Creation

One of the main benefits that FDI is thought to bring is the creation of new employment and, not surprisingly, incentives are frequently provided to encourage job creation. This may be done by granting incentives for investment in regions of high unemployment. In both the Czech and Slovak Republics, for example, the qualifying conditions for tax holidays are relaxed in regions where the unemployment level is substantially above the national average.

Sometimes, the incentive is more directly related to employment, with the creation of a stipulated number of new jobs being made a condition for qualifying for the tax holiday or other incentive. Investor in the Polish special economic zones receive a ten per cent reduction in their CIT rate for every ten new jobs created, and in some zones, located in less developed regions, the reduction is even greater. Some of the countries of the former Soviet Union, for example Armenia and Belarus, go further, and grant tax holidays in return for employing a specified number, or percentage, of disabled persons: in the latter country, veterans of the Afghan war are also included in the preferred category of employees.

Incentives based on the number of jobs created may succeed to some extent in reducing unemployment, but are obviously likely to result in inefficient allocation of resources. The tendency will be to hire, or retain, more employees than are needed, in order to reach the particular incentive threshold. The result may be that the host government is paying too much, in terms of tax revenue foregone, for the benefit of having those employees transferred from the social security rolls to the payroll of the investor. Some ongoing monitoring will also usually be necessary to ensure that the number of employees is maintained throughout the period of the tax relief.

8. Locational Incentives

Many countries provide tax incentives to locate investments in particular locations or regions within the country – from the coastal cities and special economic zones in China to the enterprise zones and renaissance zones of the United Kingdom and the United States. Sometimes the incentives are provided by regional or local governments, in competition with other parts of the same country. In other cases, the incentives are offered by the central government, often as an integral part of its regional development policy.[15] Usually, the incentives are given to promote investment in less-developed regions of the country, or in areas of high unemployment, although that is not always the case and there may be political and strategic, as well as economic, reasons for designating a region to receive preferential treatment.

Chile and China have recently introduced incentives to invest in their remote, less developed, southern and western regions (respectively). Indonesia provides additional tax benefits for investment in the less developed islands. In Thailand the country is divided into zones which are classified into a number of categories which determine the levels of tax relief to be granted to investors, and Turkey takes a rather similar approach.

An advantage of locational incentives is that they can be relatively easy to apply and to monitor. An investment is either located in the designated region or it is not. However, the legislation should make it clear that it is where the principal activities are carried on, and where production facilities are physically situated, that determines whether the investment qualifies. The place where a company is registered, or where its head office is located, may be misleading: in Russia, until a few years ago, companies were registered in Ingushetia, to take advantage of special tax reductions, even although their activities may have been conducted thousands of miles away.

Problems can also arise when an investor carries on business in some other part of the country as well as in the privileged region. In that case it may be necessary to determine what proportion of its income is derived from activities in the preferred region and to treat only that proportion as being eligible for the incentives.

D. Problems with Targeting

While targeting holds out the possibility of limiting tax revenue losses to those areas that the government feels should be subsidised, it raises a number of difficult problems. First and foremost in the context of transition countries, targeting provides significant opportunities for corruption where there is a substantial degree of discretion involved in administering the targeting provisions. Second, targeting distorts competition and, depending on the nature of the targeting, may be viewed as contrary to fair competition among firms, subject to review and possibly counter-measures.

An initial question in considering targeting is whether the granting of tax relief should be discretionary or automatic once the prescribed conditions are met. This question is elaborated in Chapter 5. For the reasons given there, discretionary powers on the part of public officials determining incentive eligibility should be restricted, as they invite corruption and rent seeking, with its negative implications. In choosing the "automatic" targeting approach, it is especially important to take account of possible abuses or misuses, as investors will naturally attempt to bring their proposed investments within the scope of the provisions that grant preferred treatment. Often this will occur in ways that have not been anticipated by the drafters of the incentives legislation. However, even where the best effort is made to limit discretionary powers and make qualification for incentives as largely automatic as possible (e.g. spelling out in detail qualifying conditions), a certain amount of discretion in the administration of those rules is generally unavoidable. Final administrative decisions over "grey areas" means that the scope for corruption cannot be eliminated when targeting is in place. On this basis, general rather than targeted availability should be seriously considered by policy-makers.

Furthermore, targeting, by its very nature, distorts competition between firms that enjoy the incentives and those that do not. In Poland, for example, there have been complaints that firms established in special economic zones are given lengthy tax holidays while other firms, engaged in the same type of production a few miles away, enjoy no tax breaks. Thus targeting can lead to a sense that the tax system is unfair, which may encourage non-compliance on the part of certain domestic taxpayers. At the same time, as reviewed in Chapter 6, various forms of targeting may be viewed by the international community as creating an unfair distortion of competition among firms and nations competing for capital, and be ruled offside. This issue, as reviewed in Chapter 6, is relevant to SEE countries seeking EU membership.

NOTES

1. See the example from Ukraine, in Chapter 6.
2. For example, joint ventures with a minimum 30% foreign ownership. This type of restriction is found in countries such as Armenia, Belarus and Uzbekistan.
3. A similar phenomenon seems to have occurred in Moldova, following the establishment of the Chisinau Free Enterprise Zone in 1995.
4. See UNCTAD (2001) at pp.24-26; Jiang, at p.653.
5. OECD (1995) at p. 85 (Estonia), 111 (Latvia) and 134 (Poland).
6. See Wong and Chung.
7. See Holland and Vann at p.999. Easson (1992) at p.411) describes a visit to an electronics firm in Malaysia that had incorporated a separate subsidiary for each new product line it introduced.
8. This process is described as the "Aladdin's lamp problem – new firms for old", by McLure at p.328.

9. For example, the Ukrainian provision to induce Daewoo to invest, described in Chapter 6. A rather similar provision was introduced by Romania in 1996, also for the benefit of Daewoo, favouring investment exceeding $50m.

10. Tax incentives for foreign participation in agricultural activities are unusual, and those activities are frequently excluded from foreign investment.

11. See Tolin (2001).

12. Tourism already receives substantial tax incentives in more traditional tourist locations, such as the Caribbean islands.

13. See Tanzi and Zee, at pp.318-319. According to McLure, even when justified such incentives are usually not cost effective.

14. There is a substantial literature on the Canadian experience with R&D incentives and the types of problems and abuses that these can give rise to: see Gunz et al.

15. In the EU, investment incentives are permitted only for certain reasons, one of which is regional development. Such incentives must be consistent with the Community's regional policy and must be approved by the Commission: see Chapter 6.

Chapter 5.

ADMINISTRATION OF INCENTIVES

This chapter addresses a number of issues surrounding the administration of tax incentives, beginning with a review of officials typically involved in tax incentives promotion, design and the granting of incentives. This raises the crucial issue of automatic versus discretionary entitlement to incentives, and scope under the latter for corruption and rent-seeking. We also examine issues relating to monitoring compliance, countering avoidance, and possible withdrawal of tax privileges.

A. Granting Incentives

1. *Who Grants Incentives?*

In countries eager to attract FDI, there may be a number of government departments and agencies involved in the foreign investment process. There is usually a Foreign Investment Agency, charged with the task of promoting investment; a government department (for example, the Ministry of the Economy or the Ministry of International Economic Relations) will approve foreign investments, where approval is needed; and the Ministry of Finance will be responsible for taxing them. There will often be other departments involved – for example, the Ministry of Tourism. Although it can be assumed that all of these agencies and departments share a similar basic goal – the well being of the country – they usually have different priorities, and it is important that their respective tasks be carefully delineated.

There are three elements or stages to consider:

- Formulation of incentives policy.
- Enactment of legislation.
- Granting tax privileges in individual cases.

It is important that all of the agencies concerned are involved in the formulation of policy and especially that all are made intimately aware of the *costs* of incentives, as well as the benefits. Unfortunately, and all too often, the tendency is for departments that are responsible for economic development to favour all measures, including tax incentives, which might increase the flow of investment, leaving only the finance ministry to protect the interests of the treasury.

Incentives legislation tends to be found in one of two places:

- Foreign investment laws, or
- Tax laws.

Frequently, granting investment incentives forms one part of the liberalisation of foreign investment laws. Consequently, it is understandable that incentive provisions are set out in the general foreign investment legislation, especially if there are to be both fiscal and non-fiscal incentives. However, the results often tend to be unfortunate. The tax provisions may be drafted with little or no regard to their relationship with the general tax provisions. (For example, the relationship between tax holidays and normal depreciation and loss rules may not have been considered.) Conflicts between the foreign investment law and the tax law are not uncommon, especially where some incentives provisions are contained in the general tax laws

and others are set out in other legislation. Incentives overlap, and provide opportunities for "double-dipping" by investors. It is therefore highly advisable that investment promotion, economic development and tax officials work together to ensure that laws and regulations providing for tax incentives (and tax measures more generally) are contained only in the tax legislation and accompanying regulations.

2. *Automatic or Discretionary Entitlement?*

An important question is whether tax exemptions and reliefs should be granted automatically where prescribed conditions are met, or should be granted only on a discretionary basis.

In favour of discretionary provisions, it can be argued that discretion reduces the potential for unintended costs of the system (in particular, it makes it easier (in theory) to restrict incentives to incremental investment). It may also reduce risks under an automatic system of the use of tax avoidance techniques to claim benefits that were not intended.

- On the other hand, it can be argued against discretionary incentives that:
- They typically lack transparency.
- They are an invitation to corruption.
- They distort competition between enterprises that receive them and those that do not (implying welfare losses).
- They impose an additional administrative burden.

Tax incentives that are entirely discretionary or completely automatic are unusual. Even where there is a high degree of discretion, the relevant legislation usually sets out the general context within which the discretion is to be exercised. Also, incentives that are "fully" automatic often require some form of certification, to the effect that prescribed conditions are met, which may involve the exercise of a degree of discretion on the part of the official charged with issuing the certification. In some countries, a two-stage process is followed: there is an automatic stage, where it is determined if the investor meets the prescribed qualifying conditions, followed by a discretionary stage, where it is decided whether that investor should be given privileges.

Further, in practice, the apparent distinction between automatic and discretionary tax privileges is not always observed. An investor that would appear to meet all of the qualifying conditions may nevertheless be denied the tax breaks. More often, the "discretion" is exercised automatically in favour of all qualifying projects. What frequently happens is that, where special incentives are granted to one investor, competing enterprises demand to be given similar privileges, with the result that incentives that are ostensibly discretionary end up being granted automatically.[1]

As a general rule, it seems advisable to keep the discretionary element to a minimum.[2] According to two well-known writers, "the track record of discretionary incentives is not encouraging".[3] In some countries the process of awarding discretionary incentives has been riddled with corruption. For example, a study of investment incentives in Indonesia concluded that, out of six large investment projects that were awarded special tax breaks, four were domestic firms that were closely connected to the then president and his family.[4] According to one FIAS advisor, "....in all too many of our client countries, the main reason why the clients want to retain discretion is to create opportunities for receiving bribes".[5]

B. Monitoring Compliance

As was discussed in Chapter 4, the more precisely an incentive is targeted, the fewer the investors who will qualify to receive it and the lower its cost will be in terms of the tax revenue foregone. Targeting serves two purposes: to reward only those kinds of investment that the host country wishes to attract and to restrict the benefit to those investors whose decisions are most likely to be influenced by the existence of the incentive. However, apart from the obvious objection that governments tend not to be good at picking winners, targeting often imposes substantial administrative costs. There is no point imposing numerous conditions on the availability of a tax incentive unless the tax administration is willing and able to ascertain whether

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those conditions have been, or are being, complied with. Monitoring compliance may be burdensome and may even be beyond the capacity of the administration.

1. *Initial Compliance with Qualifying Conditions*

Determining whether an investor meets the qualifying conditions may require:

- *Approval.*

Some incentive provisions require initial approval or some other positive decision, for example that the investment is in a priority sector, that the designated minister is satisfied that prescribed export targets will be met, or that environmental requirements will be complied with. Decisions of this nature necessarily involve some degree of discretion.

- *Verification.*

A second type of qualifying condition requires what is essentially a factual determination, for example that the foreign participation in a joint venture exceeds a stipulated percentage, that a certain number of new jobs have been created, that a particular capital investment falls within a category qualifying for accelerated depreciation, or that imported equipment can be classified as "advanced technology". Again, there may be an element of discretion involved in making some of these determinations, although others may be purely factual.

- *Valuation.*

A third category of conditions are those that require a valuation of assets – for example, that the amount invested exceeds the minimum stipulated amount required to qualify for a tax holiday, or that an investment qualifies for a tax credit of a given amount.

One should note, too, that some of these determinations will have to made regardless of any incentive provisions. For example, the value of capital investments must be verified for the purposes of the normal depreciation rules, and imported goods will normally have to be valued and classified for customs purposes. Consequently, incentives that take the form of investment allowances, accelerated depreciation or enhanced deduction usually impose little or no additional administrative burden, whereas other incentives may involve substantial extra work for the tax or customs authorities.

2. *Monitoring Continuing Compliance*

Conditions are sometimes attached to incentives that are related to ongoing performance – for example, requirements that a given number of jobs be maintained, or that a certain percentage of production be exported. Incentives of this type require continuing monitoring. To point that out is not to suggest that the performance of investors should not be monitored. Indeed, it is important for the host government to have an accurate idea of how investments are performing, especially those that have been subsidised by incentives. Without a formal monitoring mechanism, investors have little reason to make realistic projections as to the number of jobs that will be created, or the volume of exports that will be produced. Some studies have shown large discrepancies between investor prediction and performance – for example, in Ireland it was found that not much more than a quarter of the jobs promised by foreign investors ever actually materialised.[6]

However, it is also important that administrative capabilities to conduct necessary monitoring are taken into account when incentive legislation is drafted, so that unnecessary supervision is avoided. In some cases additional monitoring can be avoided by an appropriate choice of the type of incentive to be given. For example, if the incentive to create new jobs takes the form of an exemption from payroll taxes the provision is essentially self-monitoring. By contrast, a tax reduction based on the number of jobs created will require regular monitoring.

C. Countering Avoidance

A related issue is the supervision of investments to counter the possibility of abuse of the legislation. Some potential abuses have already been referred to in Chapter 4 – for example, round-tripping, new firms for old, and the sale of duty-free imports.

The most common form of abuse, however, and usually the most difficult to deal with, is transfer pricing. The tendency is to think of transfer pricing as a phenomenon that occurs internationally in transactions between related enterprises in different countries. But transfer pricing can take place internally and typically occurs where an investor has two or more operations within a country or where the investor derives income from more than one source. If one of those operations, or one type of income, enjoys a tax preference, profits will tend to be allocated to the preferred category, if possible.

As noted in Chapter 2, tax holidays are especially likely to result in this type of transfer pricing. There are, however, other types of incentives that provide no opportunity for transfer pricing or where the risk is substantially lessened. For example, investment credits or allowances provide only an opportunity to postpone tax liability rather than to avoid it entirely. Consequently, transfer pricing produces a much smaller advantage and is therefore less of a problem.

D. Withdrawal of Tax Privileges

An investor may lose the tax privileges granted to it, either because it has failed to meet ongoing requirements or has committed some violation that results in forfeiture of privileges, or it may lose those privileges as a result of changes in the relevant legislation.

1. *Non-Compliance*

An incentive provision may have a built-in requirement of continuing compliance with prescribed conditions, such as maintaining a particular level of employment or a prescribed proportion of export sales. In such cases, the investor will normally have to provide evidence each year when it files its tax return that the conditions continue to be met. Failure to do so will normally result in the tax benefit being denied for that year. Another example is where there is some change of circumstance, as a result of which the original qualifying conditions are no longer met. For example, the proportion of foreign ownership in a joint venture is reduced below the prescribed percentage, the investor moves its production facilities from a tax-privileged region to some other location, or it ceases to manufacture a particular priority product. The effect of such a change will depend upon how the incentive legislation is drafted, and also upon the type of incentive originally granted. For example, does the incentive (e.g. tax holiday) simply terminate as at the date of the change, or is there some "clawback" of an incentive previously given (e.g. duty-free importation)?

Another possibility is that the legislation may require some continuing compliance with a condition even after the tax benefit has come to an end. For example, in China tax holidays (with a total 5 years duration) are given to new investments that are intended to operate for at least ten years. If the investment terminates within the ten-year period, the investor is liable to repay the tax "spared" as a result of the holiday. Collection, of course, will not always be possible, since the most likely reason for terminating the investment is that it has proved to be unprofitable (although in such a case there is unlikely to have been any tax "spared"). The principal reason for such a provision seems to be to prevent fly-by-night operations departing as soon as they have exhausted their tax privileges, and moving on to enjoy a further holiday in a new location. To address this, foreign exchange legislation (where it exists) commonly allows an investor to repatriate the proceeds of liquidation of an investment, but only once all due taxes have been paid.

2. *Legislative Changes*

Incentives legislation does not remain static. During the past decade, countries have felt compelled to introduce new, bigger, and better incentives, although there are some countries that have reduced or

eliminated their tax incentives, usually as part of a more far-reaching tax reform. When incentives legislation is changed, how are existing investors, who are currently enjoying tax privileges, affected? Two situations need to be considered – where incentives are removed, and where incentives are improved.

If a country repeals its existing incentives legislation, it is normally anticipated that incentives already granted will continue to apply for the remainder of the period for which they were originally intended to apply. For example, an investor enjoying a ten-year tax holiday would expect to continue to do so until the end of the ten-year period; i.e. existing privileges are "grandfathered". Sometimes, there is a legal entitlement to such grandfathering. This may be expressly set out in the original incentives legislation, as a general provision in a foreign investment law, possibly as a basic guarantee under the country's constitution, or as a provision of a bilateral investment protection treaty. Even if there is no legal guarantee, the consequences of depriving investors of existing privileges can be very serious: there is probably no stronger deterrent to foreign investment than the perception that the potential host country government cannot be trusted and that promises made to investors may be broken at will.[7]

The situation may be more complicated where new tax incentives are introduced, especially where they replace incentives of a different type. The first question to consider is whether existing investors should be entitled to receive the benefit of the provisions as well as new investors. For example, should existing tax holidays be lengthened to match the new enhanced provisions? There will normally be no obligation to do so, although sometimes foreign investment legislation contains a guarantee that investors will be entitled to the benefit of favourable changes in the legislation, while being protected against adverse changes. Even where this is not the case, however, existing investors will usually advance powerful arguments as to why they too should benefit and, if the cost is not too great, the host government may find it advisable to accede to their demands, if only from a public relations point of view. A more difficult situation is where one type of incentive replaces another – for example, where tax holidays are replaced by investment allowances. In such a case, there are a number of possibilities:

- The existing investor retains its tax holiday, but is not entitled to any investment allowance for any investment made during the holiday period.
- The existing investor loses the remainder of its tax holiday, but becomes entitled to an investment allowance for any future investment.
- The existing investor is allowed to choose between either of the above treatments.
- The existing investor is entitled to retain its tax holiday *and* also to claim an investment allowance for any future investment.

The situation becomes further complicated where the foreign investment legislation contains a guarantee against adverse changes. If the new legislation removes one tax privilege and replaces it with a more favourable one, but of a different type, is the investor entitled to engage in "cherry-picking" and, in effect, retain the old privilege while also enjoying the benefit of the new one? [8]

The answers to questions such as these depend upon the way in which the relevant legislation is drafted. All too frequently, incentive legislation is introduced with little or no consideration of its impact upon existing investors. The result, inevitably, is confusion, uncertainty, bad publicity, and an adverse effect upon investment rather than the beneficial effect that was intended.

If they are to influence investor decisions, incentives need to be predictable. The qualifying conditions for incentives should therefore be set out clearly and in detail so that potential investors may determine whether or not they qualify (or what they have to do in order to qualify) for the incentive. So far as possible, the qualification rules should be justifiable, in the sense that an investor who is denied the benefit of an incentive should be able to appeal against that decision, and a court of law should be able to determine whether the decision was in accordance with the legislation.

NOTES

1. These and other factors are reviewed by Tanzi and Zee, at pp.318-319.
2. See OECD (1983) at p.59; Zee, Stotsky and Ley at pp.23-4.
3. Holland and Vann at p.995.
4. Wells and Allen.
5. Bergsman.
6. Wells and Wint at p.33.
7. It can also result in litigation, especially if there is an applicable bilateral investment protection treaty.
8. This was a question referred to the Hungarian Constitutional Court: see Deak.

Chapter 6.

TAX INCENTIVE PRESSURES AND CONSTRAINTS

A. Increasing Pressure to Compete – Targeted vs. General Provisions

Despite problems associated with tax incentives and their very disappointing track record, one continues to observe governments, primarily but not exclusively transition economies, introducing or reintroducing targeted tax measures to attract FDI. The pressures for doing so are fairly clear. Domestic job creation depends on attracting and retaining investment capital, and the investment plans of domestic and foreign firms are increasingly international. Thus there often exists an urgent sense that all possible must be done to attract a share of the action. Unfortunately, politicians and the public alike see the introduction of tax incentives as relatively easy, compared with other strategies.

The findings of this report suggest that tax incentives are not a "magic bullet", and indeed may discourage FDI where they contribute to project costs and perceived risks. The likelihood of this negative perception depends on a number of factors, including incentive choice and design, and tax administration. Despite the negative implications for incentive use in SEE countries, it is important to consider the balance of considerations, theoretical and practical, as well as the range of incentive relief on offer elsewhere in the world. The latter is important in considering how low the host country corporate tax burden should be to be competitive, and whether that burden is set by the use of special incentives, or by general measures.

B. Pros and Cons of Tax Incentives

1. *The Conventional Wisdom*

There is a fairly strong consensus among writers on the subject that tax incentives for FDI generally should not be recommended, particularly where poor design features and weak tax administration and possibly other factors would mean that significant amount of tax relief escapes to unintended recipients. That is generally the view held almost universally by theorists and by many international bodies that advise on tax matters.[1]

Tax incentives are negatively viewed by many, both in theory and in practice. Unless instances of market failure can be shown to exist, incentives may distort investment decisions and lead to welfare losses. Moreover, tax incentives often tend often to be ineffective and inefficient. Other criticisms frequently levelled against tax incentives for FDI are that they are inequitable (since they benefit some investors but not others); they are difficult to administer; they are open to abuse; and they lack transparency. Thus it is not surprising that "the standard advice given by institutions like the World Bank and the IMF to developing countries is to refrain from offering tax incentives to foreign investors."[2]

2. *Effectiveness*

A tax incentive may be considered effective if it induces a taxpayer to change behaviour in the intended manner (i.e. to do that which the incentive was designed to encourage). Investment incentives are effective if they result in investment (of the desired type) that would not have occurred but for the availability of the incentive.

As noted in Chapter 1, most studies undertaken prior to 1990 concluded that taxation was typically a relatively minor consideration in most FDI decisions. Consequently, tax incentives for investment would usually be ineffective. That proposition is broadly supported by many of the empirical studies. For example, in a 1993 survey of investors in the transition countries of central and Eastern Europe, 72 per cent of respondents stated that the availability of tax incentives had no significant impact on their strategy.[3] A 1985 study of FDI in a number of developing countries found that only two per cent of market-oriented investments were determined by incentives: however, that figure rose to 40 per cent in the case of export-oriented investment.[4]

Even though a substantial majority of investors may be unimpressed by the availability of tax incentives, there is evidence that such incentives may be an important factor in locational decisions for certain types of investment. Once a tentative decision to invest has been reached, the investor may "shop around" for the most favourable location: the availability of tax incentives may be an important item on the shopping list. It is clear, for example, that special tax incentives are one of the most important factors in choosing the location of MNE co-ordination or financial centres, and of most types of export-processing activities.

As noted in Chapter 1, recent studies show taxation to have become an increasingly important factor in FDI decisions.[5] (However, there remain significant problems in measuring properly host country tax burdens, tending to shed at least partial doubt on empirical estimates.) Governments in most parts of the world now seem to find it necessary to offer tax incentives to attract FDI, in addition to having a relatively low rate of corporate income tax. And concern over growing tax competition itself offers some evidence of the effectiveness of such incentives. (However, there are also central concerns over tax base erosions, even without significant changes in real investment behaviour.)

Nevertheless, it is often difficult to judge how effective incentives are. Governments are quick to claim credit for increased investment, which they attribute to the incentives they have introduced, and some MNE executives are quick to explain to officials that incentives have played an important role in their investment decisions. It is, of course, in the interests of both the politicians, who offer the incentives, and the investors, who take advantage of them, to claim that those incentives have been instrumental in the decision to invest, so one should probably not attach too much importance to anecdotal evidence. Overall, however, the evidence supports a conclusion that, *depending on the environment in which they are used and the investment type to which they are applied*, tax incentives may have become a more important factor in many foreign investment decisions, for much the same reasons as has taxation generally. However, as elaborated in this report, tax incentives are likely to have little impact on FDI decisions in the SEE region, owing to the investor perception of significant project risks that tend to render such tax relief as relatively unimportant.

3. *Efficiency*

An incentive can be said to be efficient (or cost-effective) if the costs of granting it are lower than the value of the benefits that result from its being granted. Ineffective incentives are almost always also inefficient, the only exception being where no one takes advantage of the incentive at all. But even effective incentives may be inefficient – that is to say, the cost of the incentive, in terms of revenue foregone, exceeds the value of the investment that has been attracted. The difficulty, for policy-makers, is to estimate the costs and benefits.

a) Costs

Investment incentives will have a cost, in terms of revenue foregone, unless they are given only to investors who would not otherwise have made the investment. Moreover, the cost is not necessarily restricted to lost revenue: the lost revenue has to be paid for, either by a reduction in the services provided by the host government or by an increase in other taxes. If a government reduces expenditure on education, health or infrastructure, the result may be to make the country less attractive to other potential investors. If it increases taxes on wages and consumption to compensate for the revenue lost on account of the

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incentives, labour and living costs will rise, again with a possible detrimental effect on other investment and on the economy in general. Some investors may be attracted by the tax incentives; others may be deterred by the consequences that flow from the costs of granting the incentives. There may, additionally, be "spillover" costs, principally resulting from the distortions created by giving incentives to some investors but not others.

Tax incentives will have a revenue cost in either of the following circumstances:

- The incentive is given not only to *incremental* investment (i.e. investment that would not have been made but for the availability of the incentive) but also to investment that would have been made in any event. or
- The value of the incentive granted is greater than that which would have been necessary to attract the investment, i.e. it is over-generous.

Thus an incentive would have a zero cost if it was given only to incremental investment and was precisely as generous as was necessary to tip the balance in favour of the investment. By contrast (and ignoring spillover costs), if no investments qualifying for the incentive were incremental, the cost would be equal to the entire amount by which the tax otherwise payable had been reduced as a result of the incentive.

A cost-benefit analysis, consequently, must begin with an attempt to determine what proportion of qualifying investment was incremental. Unfortunately, this can be very difficult, if not impossible, to determine and few attempts have been made to do so.[6] Advocates of the use of incentives tend to base their claims on the assumption that all qualifying investment is incremental: opponents, who emphasize the cost of incentives, assume that very little of it is. In practice, much depends on the qualifying conditions – i.e. how the incentive is targeted. Incentives that are given only to offshore financial centres, or to export-oriented garment manufacturers, tend to attract investment that is entirely incremental (if they attract any investment at all): they are therefore costless, in budgetary terms.[7] By contrast, widely available incentives (for example, those given to all new investment, or to all manufacturing) will usually produce only a small proportion of incremental investment.

Even where investment is incremental, it may be that the cost of attracting it has been excessive, in the sense that the incentive has been more generous than was necessary. (This can clearly be so in the case of financial incentives; the position is more difficult to sustain in the case of fiscal incentives since, in one sense, there is no cost. However, the net benefit of the investment will be less than it would have been if the incentive had been lower but had still been effective.)

b) B*enefits*

The other side of the equation requires an estimate of the benefits derived from attracting the investment. As with costs, there will be both revenue benefits and spillover benefits, although the latter will normally be the more important. Revenue benefits derive from the increased economic activity generated by the investment. The investor will pay tax on its profits (eventually), its products will be subject to sales taxes, its employees will pay income tax. Non-revenue benefits include job creation, technology transfer, foreign exchange earnings, etc. The problem is to place a value on those benefits.

One method of cost-benefit analysis that has been used is to estimate the cost (in terms of revenue foregone and/or direct financial subsidies) for each job created. For example, a 1996 study of incentives given in the United States and in Western Europe between 1983 and 1995 found the cost (of the incentive) to vary from US $13,000 to over $250,000 per new job, with the cost rising steadily over that period.[8] Although the study does not give a true measure of efficiency, since it measures only the cost – and not the worth – of the jobs created, what it does demonstrate is the sharp rise in the cost of incentives over the past decade or so. The cost of jobs, however, varies widely according to the country and to the industrial sector,[9] and the more «expensive» jobs may bring with them greater spillover benefits, such as technology transfer.

4. *Distortionary effects*

Even if tax incentives can be designed to be both effective and efficient, they may still be objected to on the ground that they distort economic decisions and are likely to result in the inefficient allocation of resources. In one sense, that objection is valid if one cannot demonstrate that existence of "market failures" calling for the use of incentives, as discussed in Chapter 1. However, on the other hand, the objection may be seen as invalid where the purpose of offering tax incentives for investment is to influence (i.e. to distort) decisions. To quote one commentator, "it does little good to advise against incentives on the ground that they cause distortion in factor or product markets, when such distortions are exactly what the client is trying to achieve".[10] The "correct" assessment rests essentially on views over the correct measurement of social welfare (e.g. national versus global), which is in large part a purely normative issue.

To some extent, special incentives may be justified on the basis that they compensate for various market imperfections: but most FDI incentives seek to do much more than that. The literature is full of examples of the distorting effects of tax holidays, investment credits, employment incentives, incentives for regional development, incentives for particular types of activity, and the like. However, most governments are likely to persist in the belief in their own ability to "pick winners" and will continue to provide special incentives as a means of influencing the allocation of resources in what they consider to be most beneficial manner.

What policy-makers rarely take into account are the unintended distortions that special incentives may create. For example, providing tax incentives for foreign investors may place domestic businesses at a competitive disadvantage, or even prevent domestic industries from developing at all. Providing incentives for new investment may place existing operations at a disadvantage: new jobs may be created while old jobs are lost. Far too frequently, tax incentives are enacted without sufficient regard to their possibly undesirable side-effects.

5. *Targeted Incentives or a Lower General Tax Rate?*

To the extent that tax considerations play a part in investment decisions, the conventional wisdom is that the general features of the host country tax system are more important to potential investors than are special incentives[11] – although there is little or no hard empirical evidence to back this up (only survey findings), given difficulties in modelling investment behaviour.)[12] It seems likely that given a choice between a 40% CIT rate but with an initial two-year tax holiday, and a 30% CIT rate and no tax holiday, most potential investors, particularly those in long-term projects, would opt for the latter. But it is difficult to believe that an investor offered a 10 or 20-year tax holiday (increasingly on offer) would still be more interested in the general provisions of the tax system. It would seem evident that if two jurisdictions competing for FDI possess roughly similar enabling conditions in other respects, but one has on offer a significantly richer tax incentive package, that location would be more attractive. However, in other cases, it is not so clear, as the attraction of low/no taxation will depend on the state of other parameters, some directly influenced by policy and others not.

One should also remember that a reduction in the CIT rate benefits both new and existing investors, foreign and domestic, which makes this very costly when viewed solely as a means of attracting incremental FDI. Of course, there may be good reasons for lowering the general CIT rate. A corporate income tax system with reasonable rates, adequate deduction rules, depreciation allowances, and loss relief, is not only an attraction to foreign investors but also promotes the growth of domestic economic activity. Special tax incentives should not be seen as an alternative to such a system. The real issue is whether, given the existence of a reasonable general tax system, special incentives may still be necessary – or, to pose the question in a slightly different way, whether special incentives are likely to achieve more, and be more efficient, than further reductions in the CIT rate.

In this context, it is interesting to consider the tax system of Ireland. It has been contended that Ireland's outstanding success in attracting FDI is in large measure due to its low taxes and, in particular, to the special 10% CIT rate for manufacturing and certain other activities that was introduced some 20 years ago. Since that rate is a "special" rate, restricted to certain types of activity, it constitutes an "incentive" according to the definition adopted in this paper. It also constitutes a specific measure for the purposes of the EC state

aid rules, which is why Ireland has moved to phase out the 10% rate: it has been replaced by a general rate of 12.5%, not restricted to manufacturing.

What makes the Irish case especially interesting is that it provides support for the contention that a reduction in the CIT rate is most likely to stimulate investment: some writers have cited the example of Ireland (along with other low-rate jurisdictions, such as Hong Kong) as evidence that a general reduction in the CIT rate is a more effective method of attracting investment than the use of special incentives. Yet that argument overlooks the fact that the Irish 10% rate was itself a special incentive, in that the rate was not a general rate. The reality is that this particular debate – whether the general tax system or special incentives are more important – is in this instance rather pointless. What has contributed to attracting many investors to Ireland is the low rate of CIT that they will be required to pay: whether that rate is the "standard" rate, or is a "special" rate, is unlikely to be of importance to the investor who qualifies for the low rate.

6. *The Relevance of Home Country Taxation*

It is sometimes argued that there is little point in potential host countries seeking to attract investment by offering tax incentives, since the benefit of the tax foregone, or "spared", accrues not to the investor but to the investor's home country. The assumption is that, where the tax credit method is employed by the investor's home country to provide relief from double taxation, as is often the case, any reduction in the amount of tax payable in the source country simply results in a reduction in the amount of credit that may be claimed in the home country, and a corresponding increase in the amount of home-country tax payable.

Such, at any rate, is the theory. Some writers have found empirical evidence to support the theory,[13] although that evidence is rather weak, and would seem to be contradicted by the evidence that lower CIT rates attract FDI. (The "clawback" hypothesis would apply equally to low CIT rates as to special incentives – in fact, more so, since tax-sparing may be given in the case of incentives but not in the case of a low general tax rate.) In practice, it will be only very rarely that host country tax reductions will increase home country tax liability, because:

- Some countries employ the exemption method to relieve double taxation, especially for income from active business.
- A number of countries that apply the credit method as a general rule provide an exemption for dividends received from foreign affiliates.
- Where the host country is a developing country, and sometimes even when it is not, its tax treaties may contain a "tax-sparing" provision which preserves the benefit of the reduction of host country tax derived from incentive legislation.[14]
- Where the investor operates in the host country through a subsidiary rather than a branch, home country tax is normally deferred (if it is imposed at all) until such time as income is repatriated to the parent company in the form of dividends, interest or royalties – the benefit of any host country tax incentive is consequently enjoyed if the subsidiary's profits are reinvested, or if they can be held in a third country that does not tax them.
- Even where the profits are repatriated and become liable to home-country tax, the parent company may be able to take advantage of excess foreign tax credits (from other investments in high-tax countries) to reduce or eliminate any liability.

In sum, with intelligent tax planning it ought not to be too difficult to avoid having the benefit of host country incentives neutralised by the home country.

C. Tax Incentives on Offer: A Review of the Evidence

1. *The Growing Use of Investment Incentives*

As noted in Chapter 1, the vast majority of changes in FDI legislation, worldwide, over the past decade have been in the direction of greater liberalisation. As part of this liberalisation, countries compete with

each other to attract FDI, and one of the most prevalent ways in which they do so is by offering tax incentives. According to a 1996 UN study, at least 103 countries offered fiscal incentives for FDI.[15]

Although there have been some instances in recent years of countries eliminating their special tax incentives, the general trend has been towards more, and bigger, tax incentives aimed at attracting FDI. Countries such as the Czech Republic and Indonesia have introduced, or re-introduced, tax holidays where previously they had eschewed them. Other countries have extended the duration of existing tax holidays to as long as 10, or even 20 years, where previously two to five years had been the norm.

2. Intra-Regional Competition

Competition to attract investment appears to be especially strong among different regions of a country, among countries belonging to a free-trade area or customs union, or among neighbouring countries within an identified region. Tax considerations do not always figure prominently in the initial decision to invest abroad, but once the decision is made to invest in a particular region, tax differences between countries in that region, or between provinces, states or municipalities within a country, may have an impact on the precise location of the investment. Certainly in some (although not all) cases they have been a key factor.

The following considers a number of recent examples in the Americas, Europe and Asia, and in specific sectors. The final section considers possible constraints over the use of targeted incentives.

a) The Americas

- Canadian provinces compete with each other in offering both fiscal and financial incentives to attract investment, despite the existence of an Agreement on Internal Trade that establishes a "code of conduct" on incentives. During 1999, Alberta, Ontario and Quebec were locked in competition to attract a Taiwanese firm, Mosel Vitelic, to establish a computer chip plant – the first two dropped out when Quebec offered substantially greater tax breaks.
- In the United States, Texas recently lost out in an attempt to attract an Intel hi-tech facility when it was unwilling to match the tax concessions offered by Arizona. According to one commentator, "… location incentives have become an ubiquitous feature of the state tax scene, and businesses have come to expect them as a standard part of their siting decisions."[16]
- In June 2000, the foreign and economic ministers of Mercosur reached an agreement on incentives for investment, production and exports and on a common motor vehicle policy. This agreement is designed to end the ongoing dispute between Argentina and Brazil regarding tax subsidies to automobile production in those countries.

b) Europe

- Despite the existence of the rules on state aid, the Member countries of the EU continue to offer generous incentives to attract investment, and within those countries different regions or cities compete with each other. In February 2000 the ECOFIN Council released a report which named 66 tax regimes within the European Union as being engaged in "harmful" tax competition: especially prominent among those regimes were special tax concessions for MNE co-ordination and financial centres.
- In February 2000 the Czech Republic, which until then had staunchly resisted calls for special tax incentives, introduced tax holidays and other concessions for new investments. The change in policy was widely seen as a response to the introduction in Poland, in 1995-97, of special economic zones in which investors enjoy tax holidays of ten years, with a further period of up to ten years at half the normal corporate income tax rate. The Polish move, in turn, seems to have been influenced by the fact that Hungary granted generous tax incentives and had, to that point, been the most successful of the central European countries in attracting FDI.[17]

c) Asia

- In 1996, the Chinese Government, perhaps convinced by the huge growth in FDI over the previous five years that tax incentives were no longer necessary to attract investment, removed a number of the tax privileges enjoyed by foreign investors (in particular, exemption from import duties on capital

goods): within a few months the level of new FDI dropped, and this was attributed by many to the removal of the tax incentives. By the end of 1997, the exemptions had largely been restored and, since then, various new incentive measures have been introduced.

- In January 1999 the Indonesian Government announced the introduction of tax holidays, for up to eight years in duration, for approved new investments. Indonesia had abolished its tax holidays some 25 years previously as part of a sweeping tax reform, but felt compelled to reintroduce them due to declining foreign investment and the fact that most of its fellow ASEAN members offer generous tax incentives. Within a few months the Philippines and Thailand both announced "enhanced" investment incentives and Vietnam followed suit in August 2000.
- The Indian budget for 2001 announced substantial new incentives, especially for infrastructure projects, with tax holidays of up to ten years.

3. *Sectoral Competition*

Some types of investment tend to be singled out for special treatment and are given additional tax privileges, either because they are perceived to be especially beneficial to the host country economy, or because they are thought to be particularly "mobile" and influenced by tax considerations. Among recent examples of targeting particular sectors are:

a) The Motor Industry

For many developing countries the establishment of a domestic (even if foreign-owned) motor industry is a paramount goal, in order to create employment and to reduce reliance on imports. Given the limited number of potential investors, competition among potential locations is fierce and generous incentives are the norm. Recent examples include:

- The incentive competition between Argentina and Brazil to attract investment by automobile manufacturers, referred to above.
- A bidding contest among states of the US, especially the south-eastern states, to attract investments by manufacturers such as Mercedes-Benz and Hyundai, both won by Alabama.
- In 1998, then President Yeltsin announced special tax incentives in the Russian Federation for automotive companies that agreed to invest at least $250 million over five years.
- Also in 1998, Ukraine, which had adopted a law that generally eliminated most of its investment incentives, introduced incentives that were confined to large projects that met only very restrictive conditions: the one proposed project that did meet those conditions was a joint venture with the Korean auto manufacturer, Daewoo.
- During 2000 there was strong competition among the Czech Republic, Hungary, Poland and the Slovak Republic, as well as from Austria and France, to attract the establishment of a planned new BMW manufacturing facility: tax (and other) incentives played a large part in the competition, with the investment ultimately going to the eastern part of Germany.

b) Electronics and the Hi-Tech Sector

One argument that has frequently been advanced in favour of FDI is that it promotes the transfer of technology, which in turn stimulates the economic growth of developing countries. Investment in electronics and other hi-technology industries is widely seen as especially desirable, providing employment, boosting exports, and modernising the economy generally. According to one recent article,[18] no fewer than 89 locations around the world now call themselves "Silicon" something – Silicon Bayou, Bog, Fen, Glen, Orchard and Prairie have been established as rivals to the original Silicon Valley. Almost all of them offer generous tax incentives to hi-tech investors. For example:

- In August 1996, Malaysia launched its multimedia supercorridor (MSC) project, intended to create a high-growth multimedia/information centre concentration.

- In 1997, Indonesia introduced tax concessions for microchip manufacturers.
- In September 1999, the Philippines' Government announced a 12-year holiday for projects that produce raw materials for the electronics industry – the measure was targeted specifically at wafer fabrication projects and was intended to align Philippine incentives with those of Taiwan and Singapore.
- Also in 1999, China set out new policies to encourage foreign investors to develop and create technology, providing special tax incentives over and above the usual tax holidays.
- Competition became still more heated in the year 2000. In March, Thailand's Board of Investment announced a new policy to attract electronics manufacturers; in May, India, which had taken an early lead in software development with its special facilities in Bangalore, announced major tax breaks to aid the country's knowledge-based sectors. Biotechnology and pharmaceutical companies are to receive a ten-year tax holiday on earnings from research and development and the tax exemptions for software technology parks are to be increased. In June, Singapore announced incentives for e-commerce and start-ups of Internet businesses; and in July, China introduced new incentives for software and integrated circuit development.

c) Multinational "Centres"

Tax competition to attract the management or "head-office" operations of multinational enterprises has been especially intense, no doubt because such operations are typically highly mobile and can be located almost anywhere in the world that provides adequate telecommunications. Mention has already been made of the special European regimes for MNE co-ordination centres, distribution centres, financial centres, and the like, currently under examination by the OECD and the EU. In the Mediterranean, Cyprus, Gibraltar and Malta compete with special low-tax regimes for the establishment of financial centres. Competition to attract such "centres" is equally strong in Asia, with Malaysia, the Philippines, and Thailand attempting to follow the lead of Singapore as a home for the operational headquarters of MNEs doing business in the region.[19]

4. Negotiated Incentive "Packages"

In the case of the largest investments, it would seem that multinational enterprises (MNEs), especially in sectors such as electronics and vehicle manufacture, now expect to negotiate special incentives wherever they choose to locate. Host governments often negotiate an incentives "package" with the potential investor, comprising both financial and fiscal privileges – where the investor may be in a relatively strong negotiating position. For example:

- The electronics giant, Intel, which has already been mentioned in the context of the competition between Arizona and Texas, has operations in more than 30 countries. In May 2000 it opened talks with the Government of Israel regarding the possible location of a manufacturing facility, which if it goes ahead as projected will be that country's largest single FDI project ($3.5 billion). Intel was reportedly seeking a "grant package" worth $600 million. At more or less the same time, Intel was negotiating with the Czech and Portuguese Governments on the location of another new plant before deciding, in November, in favour of a third location, Egypt, whose Government was prepared to offer its operation free zone status.

As might be expected, once a package has been negotiated with one major investor, others will demand similar treatment if they are to enter the same market. To give but two recent examples:

- Within days of Philips concluding an agreement (in April, 2000) with the Czech Government, under which it was to receive tax incentives for establishing a television manufacturing plant, two rival producers – Matsushita and Tyco – negotiated similar concessions;
- The Ford Motor Company returned to the Philippines in 1998 after an absence of 15 years, agreeing to build a $100 million assembly plant. It was reported to have won "concessions setting new standards for generous investment incentives", following intensive lobbying. Soon afterwards, Chrysler and General Motors made it known that they too were keen to return, if assured of obtaining similar concessions.

D. The Prisoner's Dilemma

If tax incentives for FDI are often as ineffective and inefficient as most commentators agree they are, why is their use increasing in the way described above? The explanation is rather simple. Governments, especially those of less developed countries, are placed in a dilemma. They are urged to promote FDI, for a variety of (mostly good) reasons. Indeed, the level of FDI flows into a country is often seen as an indication of that country's economic health. The competition to attract FDI is intense and most countries offer incentives, in one form or another, to attract investment.

Among developing countries, those incentives usually take the form of tax privileges, principally because the would-be host countries cannot afford to grant direct financial subsidies. Tax incentives may be of somewhat doubtful efficiency, but they have come to be expected by investors and, without them, it is understandable that host countries fear that potential investment will go elsewhere. Thus, despite the costs, governments are under enormous pressure to offer investment incentives. As one writer, commenting on the incentives competition among the states of the U.S., explains:

"The absence of empirical evidence for the economic efficacy of tax incentives does little to quell the political enthusiasm for them......By taking visible steps to encourage economic growth, [elected officials] can take credit for subsequent economic successes, whatever their actual causes, and avoid blame for any losses of jobs to other states that otherwise would have been attributed to them if they had failed to act. From a political perspective, doing something is almost always better than doing nothing..... Thus, the political costs of adopting tax breaks for businesses are lower than the costs of failing to participate aggressively in the incentives bidding competition." [20]

One might argue that, in response, countries should agree together to eliminate the use of tax incentives for investment, or to restrict their use within certain agreed limits. However, difficulties are met in defining and measuring tax incentive relief, and limits on tax incentive use would unfairly benefit countries providing financial assistance to firms by other means. Moreover, reasonable arguments can be built for using incentives, for example to address market failures. In the absence of an agreement to restrict the use of incentives, few countries are prepared to take the risk of unilaterally withdrawing from the competition. The situation is sometimes likened to the "prisoners' dilemma".[21] Indeed, the real situation may be worse. In the classic prisoners' dilemma the one who plea-bargains comes off better; but in the investment bidding war there is a distinct risk that even the winner will lose, because in order to win it will have bid too high a price. This is sometimes described as the "winner's curse".[22]

In this report it is assumed that SEE countries will need to offer for the foreseeable future tax treatment that is internationally competitive in terms of the operation of basic tax provisions and possibly also targeted incentives. Part of the objective of the report is then to identify certain tax incentive types and design features that are particularly prone to providing windfall gains to investors (tax relief without additional investment), leading the way to policy changes that will improve efficiency. Such policy changes may need to take into account possible constraints on tax incentive use imposed at the supra-national level, an issue to which we now turn.

E. Possible Constraints Over the Use of Incentives

1. Introduction – Fiscal Sovereignty

It is commonly said that there is no such thing as an international law of taxation: each sovereign state is free to determine its own tax laws as it chooses, and to change them whenever it chooses. Countries may agree, in bilateral (or multilateral) treaties to limit their tax jurisdiction in return for corresponding limitations undertaken by the treaty partner. And countries may agree to accept certain common rules, as where the Member states of the EU agree to the adoption of a directive on taxation.

However, during the past decade or so a number of international organisations have intensified their focus on taxation issues, and have adopted – or have reinforced – rules that impose some limitations on

national tax autonomy and, in particular, that impose some constraints on the use of tax incentives for foreign investment.[23]

2. The OECD

The influence that the OECD has had upon the evolution of the tax policies of its (now) 30 Member countries, and those of many non-Member countries also, is widely recognised. The OECD has no supranational legal powers, though its Members do undertake binding obligations, notably those imposed by the Codes of Liberalisation of Capital Movements and of Current Invisible Operations, and the 1976 Declaration on International Investment and Multinational Enterprises and related Decisions. Those measures do not relate directly to taxation, although tax rules may fall within their scope in some circumstances.

In 1998, the OECD took a step directed towards the use of certain tax incentives of both member and non-Member countries, with the publication of its report on harmful tax competition.[24] In June 2000, a further report was published identifying 47 "preferential tax regimes" among Member countries, which Member countries are required to eliminate by 2003.[25] In addition, the report identifies 35 tax haven regimes among non-Member countries, and possible counter-measures. Most of the relevant jurisdictions have since made commitments to the OECD to modify the features of their tax laws that were found to be potentially harmful.

The principal focus of the OECD reports is on those tax concessions targeted towards geographically mobile activities such as financial and other service activities, in particular MNE "centre" regimes. As such, it falls outside the scope of this report which focuses on tax incentives and basic tax features relevant to attracting direct investment with a significant host country presence, involving significant job creation (e.g. in the manufacturing sector).

3. The European Union

a) The Code of Conduct

The OECD action against harmful tax competition coincided with a somewhat similar initiative within the EU. In December 1997 a "Code of Conduct" on business taxation was adopted, under which the Member States agreed to refrain from certain types of tax competition. The code concerns those measures that affect, or may affect, in a significant way the location of business activity within the Union. The subsequent report of the Primarolo Group listed 66 special tax regimes within EU Member countries which were considered to offend against the code, most of which provide tax concessions to multinational co-ordination centres, financial centres and the like. Under the terms of the code, those concessions will have to be eliminated.

b) The State Aid Rules

Possibly of greater importance are the existing rules of the EC Treaty that prohibit or restrict the granting of state aids to industry.[26] Potentially, any measure that provides a special advantage to a particular economic activity, or to investment in a particular location, falls within the scope of the state aid provisions and is prohibited unless it can be justified on one of a number of stipulated grounds. The prohibition applies to aids that facilitate "certain undertakings or the production of certain goods" — that is to say, to selective provisions – and clearly includes within its scope special tax provisions.

Tax incentives that are aimed at a particular region or economic sector or at a certain function within an enterprise are considered to be specific and therefore open to investigation by the Commission. Such rules include tax holidays, reduced tax rates, investment tax credits, accelerated depreciation, and the like. Exemption may be given for aid for regional development, but such aid must be approved by the Commission and must be consistent with the Community's regional policy and be proportionate to the aim pursued. The other requirement for the application of the prohibition is that the aid must distort or threaten to distort competition and affect trade between Member States. The aid must therefore have an effect on competition

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and intra-community trade. Clearly, any provision that is designed to, or does in fact, influence the choice of business location within the EU – which is what tax incentives are all about – meets this requirement and is reviewable. In effect, all forms of special tax breaks will have to be eliminated, unless approved by the Commission.[27]

c) Accession of New Members

The code of conduct and state aid rules apply only to the Member States and (in some cases) to the associated or dependent overseas territories of the Members. Thus, they have no direct impact upon other countries – other than prospective members. Candidate countries are under the obligation to adopt, on accession, the entire *acquis communautaire*: i.e. they must modify their existing laws to comply with EU rules. As regards tax incentives, this principally means that all incentives must be consistent with the rules on state aid and with the rules of the customs union.[28] Consequently:

- Hungary will have to modify its duty-free zone regime in order to bring it into compliance with EC customs rules,[29] and to eliminate some of its tax concessions, especially those to the motor industry.
- Latvia and Lithuania have been advised that their laws on free economic zones will have to be revised.
- Poland will be required to remove some of the tax holidays granted in its special economic zones.

The case of Poland is a cause of considerable concern, because it appears that some existing investors will lose the tax breaks already granted to them. A satisfactory solution to this problem is still being sought.

d) Association Agreements

Even before accession, countries that have been recognised as potential EU Members, such as the Stability Pact countries of SEE, are to some extent restricted by EU rules, notably those on customs duties and on state aid. Potential Member countries have entered into *Europe Agreements* or *Stabilisation and Association Agreements* which, in return for a large measure of free trade with the EU, impose certain obligations on them to bring their customs legislation and their laws in areas such as competition, state aid and intellectual property into alignment with Community law. In consequence, some limitations are placed on their freedom to offer certain types of investment incentives. For example, the Europe Agreements would seem to prohibit special customs duties exemptions that are made available on a discriminatory basis;[30] and both the Europe Agreements and the Stabilisation and Association Agreements contain provisions, similar to those of the EC Treaty itself, restricting the grant of state aid.[31]

NOTES

1. For a comprehensive review of the literature see UNCTC (1992); UNCTAD (1996).

2. Avi-Yonah at p.1443.

3. OECD (1994) at p.12.

4. Guisinger.

5. See Wilson, and the evidence reviewed by Clark.

6. One study of FDI in Indonesia concluded that, of investments qualifying for incentives, no more than 20 percent were incremental: see Wells and Allen.

7. There are often spillover costs.

8. UNCTAD (1996) at pp.29-30.

9. According to a 1991 UN study, experience in export-processing zones (mostly in developing countries) suggests about US $ 5,000 per worker, although this can vary from about $1,000 per worker in textiles to more than $100,000 in the chemical industry: UNCTC (1991) at p.47.

10. Bergsman.

11. See, for example, Holland and Vann at p.988.

12. Responses to questionnaires tend to rate "taxation" as a more important factor than "investment incentives": see, for example, Wallace. In a more recent survey of US investors, 42% of respondents rated the CIT rate as important, as opposed to 39% for tax holidays: Wunder.

13. See, for example, Hines (1998). For a detailed review of the issue, see OECD (2001), Chap.3.

14. Among developed countries, only the United States consistently refuses to grant tax sparing, although other countries are becoming more reluctant to do so.

15. UNCTAD (1996) at p.21.

16. Enrich at pp.380, 384.

17. See Easson (1998a).

18. Miller.

19. A recent report from the law firm Baker & McKenzie examines special holding company regimes in Mauritius, Singapore, Malaysia (Labuan) and China: see Weisman (2000).

20. Enrich, at pp.393-96 (italics added).

21. See Avi-Yonah; Roin.

22. See Gilette.

23. Most of these constraints are reviewed in UNCTAD (1996), Chap.V.

24. OECD (1998).

25. OECD (2000).

26. For analysis of the state aid rules and their application to tax measures, see Pinto; Schon.

27. The case of the Irish reduced CIT rate for manufacturing has already been referred to.

28. See "EU Commissioner speaks on accession states' business tax breaks", *Tax Notes International*, September 28, 2001 (2001 WTD 189-22).

29. For a review of the EC rules on free zones, see Lux.

30. See, for example, art.8 of the EU-Romania Europe Agreement.

31. E.g. art. 64 of the EU-Romania Europe Agreement, and art.69 of the S&A Agreement with Macedonia. The Agreements provide that the entire territories of the non-EU party are to be considered less-developed regions, with the consequence that aids are permissible, but those aids must be granted in accordance with the guidelines of EU regional policy.