FDI, FISCAL INCENTIVES AND THE ROLE OF DEVELOPMENT POLICY

Development framework

Figure 1: The growth of sales and gross product associated with international production, GDP and exports, 1982-1999 (Index 1980 = 100)

The last two decades of the 20th century have seen major shifts in the size of cross-border capital flows (see figure 1).¹ FDI flows to developing countries and economies in transition have proved to be the source of economic growth. FDI inward increased from 50.1 billions of dollars annual average in 1985-95 to 199 billions in 1998 and 207 billions in 1999. In same time, FDI inward stocks increased from 218 billions of dollars in 1985 (9.1% GDP) to 1.4 trillions of dollars in 1999 (20% GDP). Except for a small number of countries, FDI inflows in many countries actually rose. Asia, a region that had continuously claimed the lions share of FDI lost in relative importance. By contrast, Latin America and

¹UNCTAD, World Investment Report 2000: Cross-border Mergers and Acquisitions and Development, figure I.1, p. 6
Eastern Europe gained in relative importance (see figure 2). FDI remain a major source of external finance for developing countries and economies in transition. Foreign investors expressed their confidence in the long-term prospects of many of those countries, particularly responded to the improvements in the FDI environment, which governments in those countries have introduced.

But, many questions arise from these trends. Does FDI support sustainable development? Does FDI generate taxes that support the development of safety of social net and the welfare? Does FDI help to improve corporate governance? What is the role of state incentives attracting FDI? The answers are not easy and simple, they are very complicated and complex. They cannot be answered without understanding the nature of development process.

Viewing the quantitative and qualitative sides of the general growth process we can recognize three key principles for sustainable development process:

\[FIAS, \text{Washington, October 24, 2000}\]

\[V. \text{Thomas, A. Dhareshwar, R.E. Lopez, Y. Wang, N. Kishor, M. Dailimi, D. Kaufmann:}\ \textit{The Quality of Growth}, \textit{World Bank and Oxford University Press, August 2000}\]
• Development of all three types of assets: physical, human, and natural capital.
• Stability in growth outcomes over time.
• Development of the institutional framework for good governance.

Generally speaking, in accelerating growth rates much attention has traditionally been paid to the accumulation of physical capital. But other two types of assets, human capital and natural capital are also crucial for accumulation, technological progress and productivity. Underinvestment in education and health and overexploitation of natural capital could distort the physical capital. Their efficient use and good governance are vital and as important as the accumulation of these assets.

Creating a proper climate for successful development requires an integrated approach, linking economic, institutional, legal, and other relevant elements. The actions focusing on the quality of growth need to be a core part of the integrated policy package, not an add-one, including asset accumulation and use by reducing policy distortions; regulatory frameworks by building regulatory frameworks for competition and efficiency; good governance by nurturing civil liberties, participatory processes, and accountability in public institutions promoting anti-corruption efforts.

Analyses of economic growth of developing countries suggest three different patterns of growth:

• **Pattern 1.** Unsustained growth, where the economy at first grows at a fast growth rate, but later at a declining rate, eventually leading to stagnation and welfare losses. The pattern is associated with slow and highly unstable or volatile growth. Slow and unstable growth leads to inadequate resources for investing in human capital and natural capital. This pattern usually occurs in the context of poor governance and corruption that brings about low investment and inefficient allocation of public expenditures.

• **Pattern 2.** The stop-and-go pattern of growth. Distorted growth bought at the expense of deteriorating natural resources, lagging investments in human capital and subsidies to physical capital, such as tax exemptions, allowing tax arrears, giving financial grants to reward certain investments, and providing investment credit subsidies.

• **Pattern 3.** Sustained growth through undistorted or balanced asset accumulation, with public support to develop education, improve public health, and protect natural capital. This prevents a decline in returns to private
assets (especially physical capital) and provides the minimum and increasing levels of human capital needed to facilitate technological innovation and the growth of total factor productivity.

Market reforms, including trade and capital market liberalization, privatization, elimination of price controls, liberalization of labour and other markets, have been vital instruments in increasing the rewards to all forms of capital. Given the greater responsiveness of private and FDI investments in physical relative to human and natural capital, they have helped some countries (especially those countries not severely affected by corruption) to enjoy an investment boom. Several of these reforms, for example trade liberalization, also raise the rewards to human capital. However, in the absence of investment in complementary assets (especially human capital), the expansion of physical capital could bring about a declining return and eventually a deceleration of growth.

Moreover, as developing countries participate more in global markets, national (and subnational) governments can engage in competition to attract capital by artificially creating favorable conditions, as seen in recent evidence on subsidies to attract foreign investments in developing and CEE countries. Most countries use a combination of policies to support the profitability of capital through direct financial subsidies to domestic and foreign investors; efforts to build infrastructure and services with public money oriented to expand particular industries and develop environmentally sensitive areas; as well as credit, tax, and price policies in favour of capital.

**How FDI works**

Numerous studies and analyses have tried to answer the question why transnational companies invest in developing countries and transition economies. However, all the answers can be grouped into three simple strategies:

- **Better serving of existing and new customers.**
- **Increase of competition, market share and profitability**
- **Better access to resources.**

Major factors that influence the generation of FDI in a country, i.e. the way in which transnational companies select locations for their investments, are general policy frameworks, specific policies and policy measures for encouraging business and finally many different economic factors. Let us look from the point of view of foreign investors (see figure 3):
Figure 3: Key factors for selection of FDI location

Policy framework is the first important factor. FDI require good macroeconomic and legal stability, convertibility of currency, convenient and fair privatization strategies and its visible progress, readiness of local companies to cooperate, appropriate opportunities for reconstruction of infrastructure and huge companies, as well as bilateral arrangements for protection of investments from political risks and for avoiding double taxation.

The second set of factors refers to those factors that influence business performances, such as subjective vicinity, valid and timely obtaining of the true information about a country, general political environment, current country’s image, simple administrative procedures in doing business, as well as volume of financial and market privileges.

And finally, there is a range set of factors, mostly of economic nature, such as labour costs, labour skills, integration prospects, market size and market growth, access to neighbouring and regional markets, natural resources, management skills, quality and costs of physical and financial infrastructure, efficient complementary industries and services, etc. Those factors can have a decisive impact on the investment decisions, such as unpredicted expenditures referring to corruption, efficiency of administration, social amenities (multi-language schools, quality of life), good reputation and influence of foreign investors, as well as positive climate towards the foreign investors.

Many obstacles on the state and regional level, or on the level of companies make the FDI even more difficult. The most critical ones are:

- Bureaucracy
- Corruption
• Legal and tax environment
• Inexperienced and incompetent government
• Political instability
• Democratic and industrial vacuum
• Lack of skilled and competent management and staff
• Macroeconomic and currency instability
• Weak and expensive business infrastructure
• Lack of locations and buildings
• High costs of rent
• Lack of transport infrastructure and transportation costs
• Weak academic network and weak local training infrastructure
• Problems with relocation of people and capacity

There is a strong correlation between obstacles and FDI inflows. Elimination of obstacles is the potential for FDI growth. However, the obstacles can be much easier created and defended than removed.

Current FDI practice in the CEE countries shows that the policy framework is important, but it is not a sufficient determinant for the FDI location. With the progress of liberalization, harmonization and globalization, policy framework becomes less important, while the policies for improvement of business environment and creation of friendly climate for FDI gain greater importance. Liberalization and globalization lead towards the creation of new regional markets and new FDI areas. What seems to become more critical in the coming years is a clear combination of local competitive advantages (including human resources, infrastructure, physical resources and market), created technological resources and innovative capacities, which can be offered by some country or region to the potential investors.

**The role of taxes and investment incentives**

In today’s competitive global economic world, the establishment of attractive and competitive environment for FDI has become a necessity. Many countries in the CEE region introduced many different "right" and "incentive-based" measures to set the conditions right to harness and promote their comparative and competitive advantages. The use of tax incentives for promoting FDI was one of the major strategies.

Comprehensive literature body has shown that the rule of law, stable and sound economic policies, supporting legislation and institutions and development of human capital and democracy rules were the key for FDI success. Tax incentives were useful only in cases when they were used carefully and when they were an integral part of the "package" of other sound policy measures and strategies. Literature
reports a variety of tax effects on economic performance:

- Taxation of capital income reduces the net rates of return to savings and may reduce private savings.
- Taxation affects investment directly through its impact on the cost of capital. If marginal effective tax rates vary across sectors and activities (i.e. violation of the neutrality principle), investment efficiency is affected.
- Labour taxes, in particular payroll taxes, have impact on labour supply and labour demand.
- Tax systems vary significantly across and within countries. Tax systems are thus not neutral with respect to domestic resource allocation.
- The extension of tax-financed public pension schemes may lead to a reduction in private savings.
- Personal tax progressivity penalized investment in human capital.

Total tax effects on growth demonstrate a significant negative relationship between the level of the tax/GDP ratio (or the government expenditure ratio). Generally, high taxes reduce economic growth. It is clear from the literature review and from the additional results that the effects of taxes on economic performances are ambiguous in some areas and unsettled and controversial in others. So, there could appear several ways in which tax policy could be adopted to improve economic performance and FDI inflows.

**Bosnian experience**

Almost five years after the end of war in Bosnia, and 5,1$ billion of financial donor input, the country has not yet achieved economic self-sustainability as was predicated. The GDP growth is at 50% of its target figure, the unemployment is about 40%, the imports/exports gap is 3 billion dollars per year, refugees and internally displaced persons have not yet returned to their homes, there have been only modest achievements in strengthening state institutions and policy reforms aimed to encourage private investment and FDI inflows. So, what went wrong and why?

The fundamental reasons lie in the omission of an integrated approach linking economic, institutional, legal, and other relevant development elements. Some of major mistakes were:

- The country was being patronized. Full confidence between the implementing organizations and the recipients was not established. The client had very little influence on what was to be done, what was going on in their own country, and who was doing what.
• The focus on the reconstruction was placed on the physical infrastructure, while the business environment regulation, privatization, restructuring, industry restart and job creation was neglected for too long. The project was wrongly focused.

• The time and quality aspects of the project were not properly addressed. Solutions were sought for days, months or years and many went unresolved.

• The reconstruction program did not encompass the human and natural capital. Adding to that the old-fashion socialist attitude of people, management and political structures and the political issues in the post-war period and their negative impact on the reconstruction, it is apparent that the project design were poorly assessed.

• There was a lack of coordination among different international agencies, NGOs and implementing organizations. The result was a considerable duplication of efforts in one area, while others were uncovered.

It is clear from the Bosnian experience that the building of political, state and social structure and transition from socialist to market economy with combination of international donor community’s optimism and capacity and responsibility of local policy makers was not able to provide efficient and effective mechanisms for management of a multiple transition. The initial optimism and illusion of “good results” of the infrastructure renewal process and high growth of GDP recovery fogged the essential transition problems and hid them under the carpet of Bosnian reality until some better times (development pattern no 1.). Alliance of international bureaucracy and local political “reformers” created “donor's development model” whose results were the unclear structure of transition management, slow reform process, weak entrepreneurship sector, occurrence of “voucher capitalism”, the corruption and general loss of hope.

At the Bosnian scene there are also giant problems related to the liberation of past mortgages, which are the consequence of both earlier legal and system framework, which discouraged processes of macroeconomic restructuring, as well as FDI inflows. According to the recent UNCTAD data, FDI stocks were only 410$ million. At the same time, cumulative foreign investments in some countries were as follows:

<table>
<thead>
<tr>
<th>Country</th>
<th>FDI stock ($ billion)</th>
<th>FDI per capita (4)</th>
<th>Until</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slovenia</td>
<td>4,1</td>
<td>2.050</td>
<td>December 1998.</td>
</tr>
<tr>
<td>Croatia</td>
<td>2,2</td>
<td>459</td>
<td>September 1999.</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>2,4</td>
<td>286</td>
<td>June 1999.</td>
</tr>
<tr>
<td>Hungary</td>
<td>20,5</td>
<td>1941</td>
<td>July 1999.</td>
</tr>
<tr>
<td>Rumania</td>
<td>4,2</td>
<td>185</td>
<td>August 1999.</td>
</tr>
<tr>
<td>Poland</td>
<td>40,0</td>
<td>1.033</td>
<td>August 1999.</td>
</tr>
</tbody>
</table>
Numerous obstacles created unhealthy environment for doing business in Bosnia. Those obstacles have their own deep roots in political, systemic and administrative areas. Two typical illustrations for those obstacles are current systems of public expenditure and current fiscal system in Bosnia.

From the practices and experiences of the transition economies it is visible that total public expenditures have been at the level of 45% of the GDP. But, in Bosnia, public expenditures in the 1996-1998 period averaged 62% of GDP. The provision of large amounts of donor funding has facilitated this huge public expenditure program while enabling Bosnia to maintain fiscal stability. The present level of government spending, as a percentage of GDP, is excessive. A major effort must be undertaken to enhance revenue mobilization by widening the tax base rather than raising tax rates, reducing public spending, improving expenditure management, re-balancing recurrent expenditures, or restructuring the social security system.

Some of these findings could be explained by a complicated government system, which is very decentralized. Namely, economic responsibilities of the State government are limited to areas of foreign trade policy, external debt servicing, customs policy and monetary policy (i.e. the Central Bank, which operates as a currency board). Two entity governments are in charge of all other areas. Furthermore, substantial power in the Federation is devolved to the Cantons, where the Canton administrations are responsible for public services, education, social transfers and other matters.

Sales tax, wage tax, corporate profits tax, citizens tax, customs tax, excise tax and administrative tax are the major sources of public revenue. The tax structure results in the following composition of tax revenue and tax pressure (tables 1, 2, 3 and 4):¹

<table>
<thead>
<tr>
<th>Table 1.: Tax rates and special provisions, Bosnia &amp; Herzegovina and selected OECD countries</th>
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<tr>
<td>FBiH</td>
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Table 2.: Composition of tax revenue

<table>
<thead>
<tr>
<th></th>
<th>Federation</th>
<th>RS</th>
<th>USA</th>
<th>Japan</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes</td>
<td>10.5%</td>
<td>23.5%</td>
<td>42.2%</td>
<td>46.9%</td>
<td>31.4%</td>
</tr>
<tr>
<td>Social contributions</td>
<td>30.3%</td>
<td>20.2%</td>
<td>29.8%</td>
<td>27.0%</td>
<td>37.2%</td>
</tr>
<tr>
<td>Consumption taxes</td>
<td>53.0%</td>
<td>55.7%</td>
<td>14.7%</td>
<td>13.5%</td>
<td>26.7%</td>
</tr>
<tr>
<td>Other</td>
<td>6.2%</td>
<td>0.7%</td>
<td>13.3%</td>
<td>12.6%</td>
<td>4.7%</td>
</tr>
</tbody>
</table>

Table 3.: Tax pressure (as % of GDP)

<table>
<thead>
<tr>
<th></th>
<th>Federation</th>
<th>OECD (1995)</th>
<th>OECD-Europe</th>
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</thead>
<tbody>
<tr>
<td>General government tax revenues</td>
<td>58%</td>
<td>35%</td>
<td>42%</td>
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</tbody>
</table>

Table 4.: Government revenue (excluding social contribution) as % of GDP

<table>
<thead>
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<th></th>
<th>Federation</th>
<th>Middle-income countries</th>
<th>G-7 counties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government revenue (excl. social security)</td>
<td>42%</td>
<td>23%</td>
<td>29%</td>
</tr>
</tbody>
</table>

From above tables, several conclusion can be drawn:

- The statutory corporate income tax rate is close to the average rate applied in OECD countries. However, as no dividend relief is available, profits are taxed twice (at the corporate level and at shareholder level); the combined tax rate on capital thus exceeds 50% of gross profits (when local surcharge are added).
- The wages tax rate is not excessive. However, the payroll tax is indeed high. The combined tax rate on labour thus exceeds 50% (of gross wages).
- Customs tariffs are higher than in industrial countries, but bellow the tariffs applied by inward-looking developing countries.
- The domestic sales tax rate is close to EU VAT rates and higher than rates in USA and Japan.
- The resulting tax rates on labour and capital discourage production and encourage evasion and fraud. Along with the
other impediments to doing business in Bosnia (making Bosnia a costly place to do business) one understand that income taxes cannot contribute much to fiscal revenues. A reduction in tax rates (combined with stiffer, effective penalties for non-compliance) is even likely to result in higher fiscal revenues.

Figure 4: Average fiscal pressure (including social security) as % of GDP

The characteristics of the Bosnian tax system imply that a total tax pressure (whether including or excluding payroll taxes) expressed as a percentage of “official” GDP exceeds benchmarks in both the OECD countries and middle-income countries (see figure 4). Considering (i) the absence of dividend relief, and (ii) the tax credit for re-invested profits, the investment out of new equity is penalized in favour of the investment out of retained profits. In the Federation, the sum of corporate tax rate and the capital gains tax rate exceeds the personal tax on interest income. Therefore, firms will prefer financing by dept rather than by retaining earnings.

All the above mentioned and other not mentioned obstacles make an even worse and competitive climate for both business performance in Bosnia and investments. Besides, those obstacles reduce the size of the market, increase non-commercial risks, they produce additional costs, which makes Bosnia noncompetitive for FDI. Also, a whole set of additional factor influence the reduction of potentials for GNP growth. Some analysts consider that the distortion of the economic system reduces the growth of GNP for 20-25% per year, which makes Bosnia additionally unattractive.

Conclusion remarks

Bosnian case has shown that a sustainable development
cannot be reached without integral, well-managed political, institutional, systemic and structural reforms. Each elimination of political, systemic and administrative barriers which limits economic growth and reduces the potential for FDI growth may generate a better development model, encourage private business development and facilitate FDI inflows. Taxes and incentives are only one of important factors of attracting both domestic and FDI.