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COMPETITION FOR FDI AND THE ROLE OF TAXATION
THE EXPERIENCE OF SOUTH EASTERN EUROPEAN COUNTRIES

by

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Abstract
This paper is part of a wider research on Taxation in New EU Members, carried on at the University of Pavia, under the direction of L. Bernardi, M. Chandler and L. Gandullia, and the supervision of V. Tanzi. The paper deals with taxation and competition for foreign direct investment (FDI), reporting the experience of South Eastern European (SEE) countries. The paper illustrates the general role of tax variables on FDI location decisions, considering different types of foreign direct investment (export-oriented and market-oriented FDI). With reference to SEE countries, a number of tax obstacles have been present in the past (non-transparent and unstable tax polices, international double taxations, etc.). Tax incentives targeted to attract FDI have been widely used by these countries. A key finding of the paper is the coexistence of generous but largely inefficient tax incentives (like tax holidays, reinvestment allowances, accelerated depreciation). The paper ends with some general recommendations directed to design tax policies that can be effective and efficient in order to promote FDI in countries like SEEs. It is shown that perhaps the most effective investment "incentives" is realized addressing impediments in the basic tax system (i.e. simplifying tax calculations, lowering statutory tax rates on business where possible, using a single rather than multiple corporate tax structure, streamlining complex capital cost allowance systems). More generally, providing a stable regime which is applied in a transparent and non-arbitrary fashion is essential to attract and retain investment.

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1. FDI and the role of taxation[1]

Foreign direct investment (FDI) flows to the "transition" economies of Central and Eastern Europe (CEE)[2] have risen 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. Total inward FDI for the region amounted to $ 26.5 billion in 2000, an increase of roughly five 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 per cent) has gone to four countries – the Czech Republic, Hungary, Poland and the Russian Federation.

FDI flows to the SEE Member countries of the Stability Pact for South Eastern Europe (SEE)[3] 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.

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. 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.

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[1] This Chapter and the accompanying annex are based upon a study undertaken in the context of the Investment Compact for South East Europe, a key component of the Stability Pact. The study was lead 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. A full version of the study can be found in the publication *Tax Policy Assessment and Design in Support of Direct Investment*: *A study of Countries in South East Europe*. Luca Gandullia intensively cooperated to this chapter with a careful revision. I am indebted with him.

[2] 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.

[3] The member countries are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, former Yugoslav Republic of Macedonia, Moldova (since 2001), Romania, and Serbia and Montenegro.

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 modeling 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. 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.

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.[4]

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

[4] 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. 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.

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 labor 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.[5]

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.[6]

It is widely held that export-oriented FDI is more sensitive to the host country tax burden than is market-oriented investment. 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

5 See however a 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.

6 Halvorsen, in a study of FDI in Thailand, found customs duties and import taxes to be an important factor.

considerations seem to be of the greatest importance to firms exporting services,[7] 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.

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") and to have available dispute resolution procedures. 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.[8]

7 According to the Ruding Committee report, financial service centers are the most sensitive to taxation; co-ordination centers and R&D centers 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 co-ordination centers and of almost 80 percent of financial centers.

8 This especially seems to be the case in some of the countries of Eastern Europe and Southeast Europe.

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 reinvest 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.

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. 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 recognized 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 globalization is characterized 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 recognized 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 labor – and taxation.

2. Tax considerations in SEE countries

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 behavior 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 conclusions are relevant to addressing tax impediments to FDI in SEE countries.

- 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 per cent to 25 percent 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 (and where relevant international) 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 study focuses on targeted corporate tax incentives, which have been widely used by SEE countries to promote investment. A key finding of

the study 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).

As regards the 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) but it is recognized that different approaches and variants may be chosen at the "domestic" level.

- 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-capitalization 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, labor 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.

A critical issue 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 recognize the various avenues by which domestic and foreign investors can artificially characterize 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 conclusions emerge regarding the use of 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 unconditionally promoting the use of accelerated depreciation it is not suggested, it is recognized that policy-makers have to respond to political pressures to introduce incentives to promote FDI. Given this, there may be relative advantages with this form of tax incentive. Some support can also be 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 labor-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 behavior 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 minimize 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.

Perhaps the most effective investment "incentives" is realized 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; liberalizing 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). Also providing a stable regime which is applied in a transparent and non-arbitrary fashion is essential to attract and retain investment.

Lastly, there are a number of issues raised with the targeting that arise with incentives which, by definition, provide targeted rather than generally available tax relief. A number of general conclusions may be drawn.

- Targeting incentives specifically to foreign investors creates distortions to the extent that foreign investors favor 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 characterizing "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 organization 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. subsidizing 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 programs 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-capitalization 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 program, 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, there may be 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 need to implement base protection rules (e.g. transfer pricing rules, thin-capitalization 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 move in the direction of the arguments elaborated in this Chapter.

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 – SEE countries may wish 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 recognizes 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. Having said that it is unchallenged that there is pressure on SEE countries to offer a list of special incentives given the fierce competition for FDI within the region 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.

Annex: Tax systems, rates and incentives in SEE countries

This section reviews host country tax systems, tax rates and incentives in SEE countries, with a focus on direct taxation and corporate income tax in particular.

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 I shows where basic corporate income tax rates stood

CHART I ABOUT HERE

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

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.

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).

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 per cent (FYR Macedonia) to a high of 40 per cent (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 per cent to about 53 per cent of wages. In most of the countries the largest portion is paid by the employer.

Investment Incentives

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, 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.

TABLE 1 ABOUT HERE

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 per cent) 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 per cent of taxable profit, for example, whereas its general allowance is subject to a 25 per cent. Similarly, the Republic of Srpska caps its allowance at 15 per cent. 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 per cent rate, which is supplemented with accelerated depreciation provisions which boost the first year deduction to 70 per cent of qualifying investment expenditures.

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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).

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 per cent 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 per cent 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. n 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 per cent) 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 per cent, 75 per cent, 30 per cent) over a three-year period. Foreign participation of at least 30 per cent (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 per cent 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 per cent 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 per cent foreign ownership requirement), followed up with a 50 per cent profit exemption for two years. For priority investment projects (in excess of $ 5 million), the 50 per cent 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.

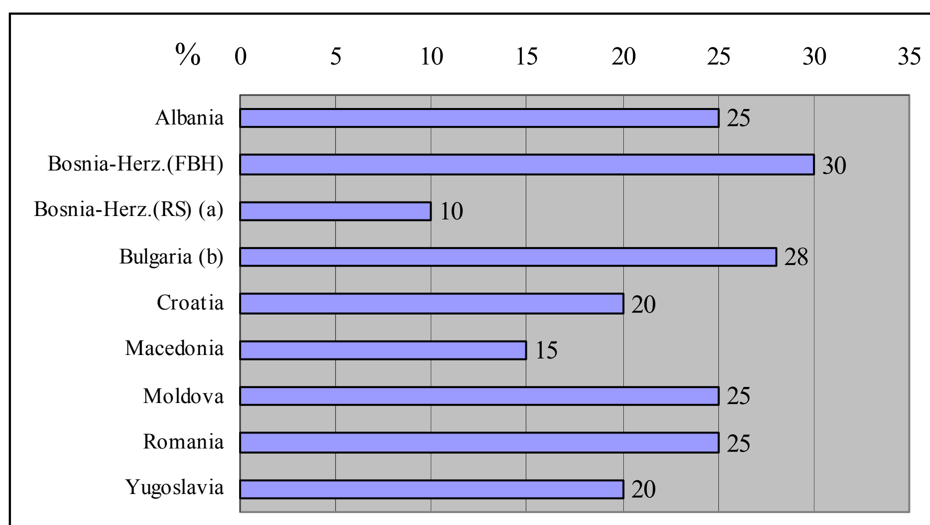
A particularly striking and important finding is that one currently observes a perplexing combination of generous tax incentives in a number of SEE countries, alongside restrictive rules governing basic tax treatment (e.g. treatment of losses). Other tax impediments to investment are also observed, including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

Tab. 1 - Investment Tax Incentives in SEE Countries

	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*s:These provisions apply as of 2001. Table reports incentives available for new investment (ignores “grandfathering” provisions).

Chart I: 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 Srapska.
(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).