

**INVESTMENT INCENTIVES IN TRANSITION ECONOMIES**

**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT**

**Paris**

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## FOREWORD

Given the intensifying global competition for scarce investment resources, both OECD Member countries and countries in transition to a market economy have established policy frameworks to promote foreign direct investment (FDI). Many of them provide incentives to foreign investors as a part of their overall investment strategies. The basic issues raised by incentives, including, for example, their implications in terms of tax revenue loss and targeting specific sectors, regions or objectives, tend to be similar for Member countries and transition economies and do not depend on the specific framework in place.

The Sixth Plenary Meeting of the OECD Advisory Group on Investment (AGI) was held on 3-4 June 1996 in Bled, Slovenia to assess the benefits and costs of FDI incentives in general and in transition economies in particular. It examined the motivation behind offering incentives, the techniques employed and experience with incentives from the points of view of both government and the private sector.

The main policy recommendations that resulted from the meeting were:

1. National treatment should be applied to give domestic and foreign investors equal access to incentives;
2. Incentives should be targeted to achieve broader economic policy objectives, such as encouraging R&D, upgrading technology, sectoral development and/or regional development; and
3. Regional incentive schemes should be consistent with national legislation, so that the overall regulatory framework is transparent.

The meeting found that, while there was wide agreement that investment incentives are just one of many important factors that influence investment decisions, most governments offer a variety of financial and non-financial packages in order to attract FDI. In order to reduce the need for incentives, transition economies should give clear policy priority to the removal of obstacles to foreign investment and to the creation of a favourable legal and institutional framework for FDI. Dialogue, trust and reliability were identified as the leading principles to guide governments in establishing a conducive investment climate. Participants acknowledged that international co-operation among host countries would be desirable, especially among neighbouring countries in order to reduce the competitive character of incentive policies.

This report includes the issues paper, background papers and different presentations made at the meeting. It is published on the responsibility of the Secretary-General of the OECD.



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*Chapter 1*

**INTRODUCTION:  
BACKGROUND AND CONCLUSIONS**

*by*

Barbara Peitsch

Administrator, Financial, Fiscal and Enterprise Affairs, OECD

**Overview**

The Sixth Plenary Meeting of the OECD Advisory Group on Investment (AGI) took place on 3-4 June 1996 in Bled, Slovenia. Senior policy makers from transition economies and OECD Member countries as well as representatives from multilateral agencies (World Bank, EBRD and the European Commission) and from the private sector met to discuss foreign direct investment (FDI) incentives.

The meeting, which was opened by Ms. V. Ravbar, State Secretary of the Slovenian Ministry of Economic Relations and Development and Mr. J.-P. Tuveri, Deputy Director of the OECD Centre for Co-operation with the Economies in Transition (CCET), was divided into three plenary sessions and two working groups:

<b>Opening Plenary</b>	<i>Costs, Benefits and Implications for Policy</i>
<b>Session II</b>	<i>Incentive Policies in Selected Transition Economies</i>
<b>Working Group I</b>	<i>Case Studies on Financial Incentives</i>
<b>Working Group II</b>	<i>Case Studies on Non-Financial Incentives</i>
<b>Closing Plenary</b>	<i>Conclusions and Future Work</i>

In addition, there was a special session to brief all interested participants on the status of the Multilateral Agreement on Investment, provided by Mr. R. Ley, Head of the Capital Movements, Investment and Services Division of the OECD's Directorate for Financial, Fiscal and Enterprise Affairs and several members of the OECD Committee on Investment and Multinational Enterprises.

While, as to be expected, no consensus was reached on the need and scope of FDI incentives, three key policy recommendations resulted from the discussion:

1. National treatment should be applied to give domestic and foreign investors equal access to incentives;

2. Incentives should be targeted to achieve broader economic policy objectives, such as encouraging R&D, upgrading technology, sectoral development and/or regional development;
3. Regional incentive schemes should be consistent with national legislation, so that terms and conditions are as transparent as possible.

### **Opening plenary: Costs, benefits and implications for policy**

The global competition for foreign direct investment is intensifying as more and more countries open their economies. Because capital resources are limited, many countries within the OECD area and elsewhere offer increasingly generous incentive packages in order to attract FDI. These incentive policies can only be justified if they induce investment which in some measurable way benefits the economy, and which would not have taken place otherwise. In other words, incentive policies are justified if the benefits generated by the investment outweigh the costs of the incentive.

Incentives may lead to distortions in prices and competition. In spite of the distortions they create, there are three situations under which the provision of investment incentives may make sense from a policy perspective. The first is to capture positive externalities. Foreign investors often generate positive externalities, such as training workers, opening foreign markets to local suppliers, and the transfer of technology and management know-how. In this case, the incentives offered are the price paid by the host country to benefit from the externalities.

The second is to compensate for locational disincentives, such as poor infrastructure, complicated bureaucratic procedures, or the high cost of business services. The theory behind offering compensation for disincentives is similar to that which supports infant industries -- governments need time to improve infrastructure, streamline procedures and build competition in the provision of services. This compensation should therefore be temporary by nature.

Finally, incentives may be justified as countervailing measures to other (particularly neighbouring) countries' incentives. In this case, countries should determine up-front that the costs of such measures do not outweigh the benefits.

Assessing the benefits of incentives is difficult, as is evaluating their costs. The effectiveness of incentives can be measured in either absolute terms, in which a change in policy directly leads to an increase in investment, or relative terms, in which the benefits outweigh the costs, or in which the incentives achieved the policy objective better than other policy instruments would have.

Most of the OECD Member countries offer investment incentives, and therefore seem to believe that incentives attract FDI that would not have taken place otherwise. This is particularly true in the case of mobile investment, which is not dependent on a certain resource.

Although a number of studies which examined the role of incentives in attracting FDI found that incentives were not decisive (OECD/Arthur Andersen 1994 and UK/KPMG 1995), a May 1996 study undertaken by Deloitte Touche for the European Union (EU), determined that 58 per cent of foreign investors in Ireland were influenced by tax incentives.

Investors typically take four key factors into account when choosing their investment location:

1. *Security of the investment:* This includes macroeconomic and political stability, political philosophy, a transparent legal and regulatory framework, and the availability of insurance against political risk.
2. *Market share:* Access to large markets is important, as is some form of trade protection.
3. *Return on investment:* The investor will take into account taxation, business costs, productivity of the workforce, currency stability, repatriation of profits and incentives.
4. *Ease of negotiation:* A one-stop-shop is often the best way to facilitate this.

Since many factors influence the decision as to where, and in what form, to invest, host country governments should therefore regard selling their countries as a marketing exercise. Governments must first clearly define their economic development objectives and determine the role of foreigners. Once a development strategy has been articulated, investment promotion becomes a marketing problem -- what is a country selling? The country's strengths and weaknesses have to be identified and incentives may be considered to overcome certain weaknesses.

Policy makers in transition countries do not always have realistic expectations concerning the role of FDI in economic development. FDI should complement domestic investment, not replace it. The attitude toward FDI in the region is often that FDI is welcome, but foreigners are not. There is clear concern in many of the transition countries that FDI will adversely affect their national identity and culture.

Of the nine OECD Member countries surveyed, all nine offer grants in one form or another. Eight offer grants toward fixed assets, seven pay grants for job creation, five offer grants for training, and nine for R&D. All nine OECD Member countries offer low interest loans, six offer rent subsidies and three provide interest subsidies.

The experience with investment incentives in Eastern Europe has been markedly different from that of OECD Member countries. All transition economies considered FDI key to the transition process in 1989/90. Foreign investors were considered preferable to domestic investors and were offered generous tax holidays and sometimes monopolistic positions or other forms of market protection. Domestic investors were discriminated against. Most efforts to attract foreign investors through incentives failed, however, due to a poor business climate (macroeconomic and political instability, a weak financial sector, inconvertible currency, etc.).

Over the past years, transition economies have begun to recognise the importance of domestic investors as well, and many now apply "national treatment", or at least offer domestic investors the same conditions. There has been a shift away from automatic incentives toward more discretionary, company-specific ones. There has also been a shift from incentives offered at the national level to incentives offered at the regional level. Regional incentives are not always consistent with national policy. These new trends tend to follow the pattern in OECD Member countries more closely.

## **Session II: Incentive policies in selected transition economies**

The investment and incentive policies currently in place in transition economies differ widely. Countries like the Czech Republic and Estonia have abandoned incentives altogether and instead rely

on a more stable and transparent business climate to attract investment. Other countries in the region feel that incentives are necessary to compensate for shortcomings in their economic performance and/or legal framework for investment and business activity in general. Most transition economies still offer incentives to foreign investors. Financial incentives, and in particular tax holidays, are the most common.

The regime for foreign investment in Russia has been changing constantly since 1987. The two key features of the Russian FDI law are national treatment and the wide use of fiscal and tariff incentives. Some characteristics of this regime are:

- the very high threshold of investment that has to be met in order to benefit from the incentive package;
- an unstable and unclear framework for investment and incentives; and
- a gap between legislation and the application of incentives.

In Bulgaria, national treatment also prevails. Some fiscal incentives exist, but the government is moving toward a global investment strategy aimed at promoting the privatisation process with fewer incentives. At the moment, however, the tax laws are being amended to provide not only a more attractive tax system which is to include depreciation allowances and loss carry forwards, they are also likely to include more generous tax holidays.

In the cases of Russia and Bulgaria, incentives, tax incentives in particular, have not succeeded in attracting large amounts of FDI to date. This is mainly because the general framework conditions are not yet met. Market potential, and favourable macroeconomic, political and business conditions undoubtedly constitute the main factors in attracting FDI. For countries such as Bulgaria and Russia, managing inflation and other economic problems, providing a stable and transparent legal framework, investing in infrastructure and improving the financial system are the key priorities. It is important to eliminate all disincentives to FDI before concentrating on incentives.

Ukraine is another example of a country that provided a host of generous incentives, both automatic and discretionary, in an attempt to attract much needed FDI. Between 1992 and 1994, investors received tax holidays on 100 per cent of their profits for up to ten years. The incentives offered did not lead to any appreciable increase in FDI however, due to poor business conditions. In addition to macroeconomic and political instability, the legal framework for FDI has changed constantly and has been poorly implemented.

Rather than the use of massive incentive packages, the emphasis was put on improving the transparency of all aspects of FDI policy. National treatment was considered a priority (although national treatment is provided only in the FDI legislation which is secondary to domestic legislation) as FDI is not a substitute, but a complement to domestic investment. State regulations in general should be clear and stable, and guarantees against expropriation, and to allow for the repatriation of profit and other income are highly desirable.

The need for incentives often depends on the nature of the investment, whether it is greenfield or an acquisition of an existing asset. In the framework of privatisation, incentives are usually not necessary due to the inherent value of the asset. Competition induced among bidders for a specific asset being privatised is sufficient, and there is no need to sweeten the deal. On the other hand, there might be a case for the use of incentive packages to encourage joint ventures, greenfield investment,

or in particular, mobile investment. There is a preference to target specific long-term investment projects, and, where incentives are offered, they should be included in a well-thought out and designed global strategy for FDI promotion. This strategy should focus on the type of investment desired, the form it should take, sectors to be targeted and regions to develop.

In cases where incentives are provided, their delivery must be improved. In many cases, the legislation concerning automatic incentives is not stable, and incentives promised are often not delivered. It was also suggested that transition economies should concentrate on providing primarily non-financial incentives, in order to reduce direct competition with OECD Member countries in the area of financial incentives.

### **Working Group I: Case studies on financial incentives**

Financial incentives, which provide the investor with direct financial compensation for his/her investment, are the most commonly used incentive in transition economies. Financial incentives are typically offered in the form of grants or tax relief.

Most tax incentives are automatic, although they can be offered on a case-by-case basis as well. Many OECD Member countries offered tax incentives up until the mid-1980s. In the 1980s, OECD Member countries began to move away from tax incentives as they found them to be relatively ineffective. In most cases, the cost of foregone revenue exceeded the benefit of incremental investment. In Central and Eastern Europe, officials are now finding that the costs often go beyond the purely fiscal costs. Tax avoidance has increased and has become more difficult to detect, and the monitoring of incentives creates an unnecessary burden on tax services, which are newly developed.

Both Poland and Ukraine offer sizeable domestic markets to potential investors, which has generated interest on the part of investors. Instability and weak framework conditions, especially in the early stages of transition, however, diverted investment and led to the provision of fiscal incentives.

In the case of Poland, some foreign investors entered the market when the 1988 Law on Foreign Direct Investment was still in place, by forming joint-ventures with existing Polish (usually state-owned) companies. The 1988 law allowed for a three year tax holiday. In the case of F.M. Forte, a German investment into a manufacturer of wood furniture, the tax holiday was probably not decisive in the initial investment decision. However, the company grew rapidly in terms of sales, exports and number of employees. This growth can be attributed, at least in part, to the fact that the company was able to reinvest the majority of its profits during the first three years due to the tax holiday.

Other investments in Poland were based on its large domestic market, its low cost, skilled labour and its favourable location in Europe between East and West, rather than on the incentives offered. A Royal Institute study found that companies first decide on a country, secondly on a location within that country, and finally on the form of investment. Incentives play a relatively minor role.

Poland has recently created free economic zones in an attempt to attract FDI into regions which have been the most adversely affected by the breakdown of COMECON. Although investors can receive up to a 20 year tax holiday in these regions, the incentives (which are only available to foreign investors) have not stimulated any new investment so far.

Ukraine has had a similar experience with tax incentives. Between 1992 and 1995, the Ukrainian foreign investment law provided generous (up to ten years for some sectors) tax holidays to investments over a certain size. The investment legislation was also fairly liberal, although it was amended or changed by decree many times. Tax incentives were not enough, either, to stimulate significant FDI flows, as Ukraine only attracted \$150 million up to 1 January 1995. Hyperinflation and political instability (two Presidents and seven Cabinets) acted as strong disincentives to investment.

As of 1 January 1995, the formal tax holidays and other automatic incentives have been eliminated. The new law does allow for incentives to be offered on a case-by-case basis for investment in certain sectors and/or regions, but it is not clear how this will be implemented. Since 1995, FDI in Ukraine has doubled to over \$300 million. This is an indication that the business conditions are improving because the extension of incentives has been limited since then.

## **Working Group II: Case studies of non-financial incentives**

For the purpose of the discussion, non-financial incentives were defined as schemes that do not provide direct financial compensation, even though eventually the benefit to the investor would be measured in financial terms. Examples of non-financial incentives include import protection, the covering of training costs, exclusivity rights, state provided land or buildings, commercial zones, and infrastructure and telecommunications improvement.

In both the Czech Republic in the case of the Volkswagen investment, and in Uzbekistan with respect to the British-American Tobacco (BAT) investment, the governments agreed to generous concessions, namely import protection and exclusivity rights, as part of a global strategy aiming at turning the first big foreign investment project into a “showcase”. The incentive package provided a relatively riskless one-time test, designed to make this investment project particularly successful, and to give a positive signal to other potential investors. In the case of the Czech Republic, the VW-Skoda deal was seen as very successful, not only for this company, but also for the country. Many foreign investors followed this first case closely, and its success convinced them of the potential of the country, even though the government had decided to stop providing incentives altogether.

Non-financial incentives were viewed in this case with a positive eye, as a multiplier effect took place. VW was followed into the Czech Republic by its suppliers, which created forty joint ventures and fifteen greenfield investment projects. When a project reaches this scale of operation, the benefits of providing incentives are more likely to outweigh the costs.

In the case of the British American Tobacco investment in Uzbekistan, the deal is too recent to draw definite conclusions. However, the Uzbek government is satisfied with the current situation. The investment made by BAT was also seen as a “showcase”, to demonstrate to potential investors that it was safe and commercially viable to invest in Uzbekistan. The incentive package, a five year exclusivity right for production and import duties on BAT's competitors' products, was perceived by the Uzbek Government as essential to BAT's investment decision. Given that BAT's major competitor, Philip Morris, was already strongly represented in the region, the Uzbek government felt it to be necessary to provide some protection. BAT also offered guarantees in terms of the amount it will invest in the region. So far, both parties are optimistic about their future co-operation.

Nevertheless, many investments that enter because of non-financial incentives do not stimulate additional investment. Investors reap the benefits, with no, or little, positive contribution to the host country. Even though non-financial incentives might add some weight in the investment decision, the most important factors are still macroeconomic and political stability, the general business climate, and specific conditions such as skilled and cheap labour.

Both VW and BAT invested in existing facilities. It would seem that this should have decreased the need for incentives. Such vehicles as tender offers can act as a means to enhance the bargaining position of the host country in the case of privatisation of existing assets. On the other hand, non-financial incentives may still be a useful tool in order to attract large scale greenfield investment.

Governments face the choice of automatic vs. project-specific incentives. From the private sector point of view, companies may not have the time nor the resources to look for the best deals, and when their mind is set on a country, incentives are not always important. Because they are much easier to handle, automatic incentives would therefore be preferable. On the other hand, a degree of flexibility should exist in the negotiation process on the government side. All investment projects are different and require different solutions. In this context, some discretionary non-financial incentives should be available.

In conclusion, even though the overall conditions prevailing in a country, as well as the lack of obstacles, are by far the most important factors in the investment decision, it is possible for non-financial incentives to “pay off” when the host country has set clear objectives in the framework of a global investment strategy. Yet, there is no general recipe for the successful use of non-financial incentives. This will depend on the level of development of the host country, the specific strengths it offers with respect to the project, previous FDI and the type of investment project under consideration.

## **Conclusions**

Liberalisation, deregulation and privatisation in many countries have increased the global competition for FDI. While there is wide agreement that investment incentives are just one among many important factors that influence investment decisions, most governments offer a variety of financial and non-financial packages in order to attract FDI.

Incentive policies are also a feature of many transition economies, though large differences in attitudes and approaches exist. Very few transition economies have completely abandoned incentive schemes. Participants agreed unanimously that clear policy priority should be given to the removal of obstacles to foreign investment and to the creation of a favourable legal and institutional framework for FDI before engaging in investment incentive schemes. Dialogue, trust and reliability were identified as the leading principles to guide governments in establishing a conducive investment climate.

The following characteristics are common to the majority of transition economies concerning FDI incentives:

- The more advanced transition economies provide national treatment to give domestic and foreign investors equal access to incentives;

- Automatic incentive schemes are often complemented by discretionary incentives to allow for tailor-made treatment of primarily large investors -- a feature closely related to the showcase character of prestigious investment projects that are turned into important marketing devices by investment agencies;
- Regional incentive schemes are offered in addition to nation-wide promotion measures to reflect geographically oriented policy objectives.

Participants expressed the need for a systematic evaluation of incentive schemes to gain a better understanding of their effectiveness, their budgetary implications and the requirements for implementation and monitoring.

Participants acknowledged that international co-operation among host countries would be desirable, especially among neighbouring countries in order to reduce the competitive character of incentive policies.

Finally, the role of investment agencies in providing and disseminating information on the economic situation of a country and its investment conditions was stressed independently from the existence of investment incentives. Active information policies were also regarded as essential “for internal consumption”, aiming at a better understanding of foreign direct investment among the broader public and politicians of transition economies.

## *Chapter 2*

### **ISSUES FOR DISCUSSION<sup>1</sup>**

*by*

Alexis Kalmanovitz

Consultant, Financial, Fiscal And Enterprise Affairs, OECD

#### **I. Introduction**

Foreign Direct Investment (FDI) incentives are frequently offered in OECD Member countries as well as in transition economies. Their purpose is to attract as much foreign capital as possible in a globally competitive environment.

The Sixth Plenary Meeting of the OECD Advisory Group on Investment (AGI) will assess the benefits and costs of FDI incentives in general and in transition economies in particular. It will examine the motivation behind offering incentives, the techniques employed and experience with incentives from both government and private sector points of view.

There is no generally accepted definition of FDI incentives. For the purpose of this meeting, FDI incentives will be defined as measures designed by the governing institutions of a country, over which they have direct control, and that they can modify or eradicate at any time.

Such factors as macroeconomic and political stability, the business climate and natural resources seem to be the main determinants in an investment decision. However, government does not have direct control over these factors in the short-run. Therefore, they will be defined as investment attractions, not as incentives, and will not be discussed directly in this paper.

#### **II. Policy implications of FDI incentives**

Both OECD Member countries and transition economies have put policy frameworks in place to promote investment, foreign and domestic. Many of them provide incentives to foreign investors as a part of their overall investment strategies. The basic issues raised by incentives, and, for example, their implications in terms of tax revenue loss or targeting specific sectors, regions or objectives tend to be similar for Member countries and transition economies, and do not depend on the specific framework in place.

According to an OECD/Arthur Andersen Survey conducted in 1993 with private investors, investment incentives have little influence on corporate decision-making and have no significant

<sup>1</sup> This paper was prepared in advance of the meeting to guide discussion.

impact on their strategy. Most corporates are adopting a “country specific” approach to the market, prioritising and targeting location on a case-by-case basis. The key priorities are the economic climate, market size and access and the political climate.

The general attitude of investors toward incentives is that:

- these are short-term benefits only, secondary to a long-term business view, and not significant enough to influence the investment decision;
- if the investment is not successful on a stand alone basis then it is not worth pursuing, and in such instances incentives are at best incidental to the investment decision, but are usually irrelevant;
- in many respects, particularly in the case of tax holidays, the incentive is meaningless due to losses rather than profits in the early start up years. Against the background of these empirical results, a number of questions arise:
  - In practice, have incentives attracted FDI that would not have taken place otherwise?
  - Can incentives lead to investment in sectors or in locations that are sub-optimal from an economic point of view, but perhaps justified for political considerations?
  - What could be the distortionary effects of FDI incentives? Can they be measured? How do governments measure the benefits of FDI? Are they greater than the costs of providing incentives?
  - Does experience show that the distortionary effects of incentives are overcome by the benefits brought about by extra FDI? Is there a net benefit to the country that offers FDI incentives?

In order to provide answers to these questions, the nature of incentives has to be identified:

- Incentives can be automatic or discretionary.
  - In transition economies, are incentives offered automatically to foreign investors, or are they dealt with on a case-by-case basis? Is it easier to implement automatic incentives? What are the costs and benefits of automatic incentives vis-à-vis discretionary incentives? Are discretionary incentives less transparent?

Incentives can be provided both to domestic and foreign companies on the basis of national treatment, which is the case in most OECD Member countries, or only to foreign investors, discriminating against domestic entrepreneurs.

- Can discriminating incentives actually inhibit domestic entrepreneurship? Should incentives be provided only to foreign investors who choose to form partnerships with domestic entrepreneurs? In this case, can discriminatory incentives promote domestic entrepreneurship?

Incentives frequently take the form of favourable tax provisions. The relationship with the overall tax rates, which are important factors in the investment decision, is a critical issue in the discussion.

- Are generally low tax rates more attractive to foreign investors than actual tax incentives? Are generally low tax rates more or less costly to governments than incentives? What are the methods employed by governments and by private investors to measure the gains and costs brought about by different tax rates and specific incentives? Do measures ex-post match ex-ante evaluations?

Targeting is one approach to offering FDI incentives. In order to minimise the budgetary costs and the risks of fraud, while maximising the effect on the investment decision, incentives may have to be targeted toward a precise type of investment projects and/or linked to domestic development objectives. When this is the case, more FDI may be attracted and the countries that provide the incentives will have tighter control over the economy. There are risks associated with targeting, however. Governments may be driven by short term political considerations (notably electoral cycles) rather than longer term economic objectives.

Some FDI incentives, especially tax holidays, often tend to favour short-term, high profit companies which stay in business only for the duration of the incentives. These companies invest little capital, create little employment, or create employment only for a short time, and involve no transfer of technology. Incentives can be general or targeted toward specific sectors, objectives or regions.

- Should sectors or projects be targeted? If incentives are precisely targeted toward longer-term investment, will they be more effective?
- How can incentives be targeted? Can Export Processing Zones be considered as a way to target investment? Do Free Trade Zones attract FDI at the expense of the other regions of a country?
- Is there an incentive competition between regions of a country? Should every region be given specific objectives or economic sectors to target in order to avoid this competition?

In terms of targeting and monitoring, the Asian experience of FDI incentives is different from the US/EU experience. Most incentives are financial, and they are precisely targeted. Most of them are granted, after thorough examination, to investment projects in automated production equipment and technology, in R&D and personnel training, in areas with scanty natural resources or slow development, or in investment leading to the establishment of the international image of locally-made products.

In Asia, the qualification requirements, the application procedures and the legal enforcement are strict, but transparent. Fraud seems to be virtually non-existent, and the results are impressive: FDI in the region has been high for the past ten years.

- What has been the role in Asia of incentives as opposed to low labour cost, high saving rates and other factors?
- In view of the Asian experience, is it possible to expect the same success by applying the same investment policies in transition economies?

### **III. Country experience of incentive policies**

The experience of transition economies with investment policies, including incentives, is limited. Because such policies are relatively new, implementation has often been inconsistent and the results have been hard to monitor. Most governments in the region are still in the process of evaluating the success of their investment programmes, and the costs and benefits of the incentives they offer.

In addition to the numerous issues raised by incentives in general, it can be argued that even a marginal influence on the investment decision is significant, that incentives are a sign of commitment and openness to foreign direct investment, and that, all other things being equal, regions where

significant incentives are available would take priority. Consequently, there seems to be a rationale for incentives, at least in specific cases.

- Even if it might be a marginal criterion for choosing between investment locations, can the availability of incentives provide a sound enough basis for investment?
- Can incentives compensate for an inadequate climate?
- What are the preferred incentives in transition economies? After they have evaluated the results of such schemes, have governments changed their attitude toward incentives?
- Tax incentives are difficult to cost in advance, and these costs can take time to work through (because newly established enterprises often make losses initially). If the incentives are then found to be too costly, compared with other more direct incentives, it can prove difficult to reverse them without undermining the stability of the tax system for inward investors. Is it possible that the uncertain costs of tax incentives can lead within a few years to changes which reduce the stability which inward investors seek?

The benefits of FDI incentives will be experienced only if they attract “extra” FDI, that is, if the incentive package offered to an investor will make the difference in his decision. In this case, the net benefit will consist of the direct positive contributions and externalities of the FDI project minus the opportunity cost of providing the incentive package. The direct positive contributions can be quantified in terms of capital creation, new employment, the use of domestic suppliers, etc. In other words, in terms of wealth created. The positive externalities are more difficult to quantify, as most of them are intangible: transfer of technology, creation of competition, country promotion, etc.

The opportunity cost of providing incentives is higher than just the actual amount disbursed by the government and/or the average foregone tax revenue. In the framework of grants or subsidies, this capital could be used for the reconstruction of the industrial base, promotion of employment or any other domain related to macroeconomic stability and economic growth. In the framework of tax breaks, the expected loss of revenue may not match the actual loss of revenue. If the company that benefits from such an incentive happens to make large profits rapidly, the government will actually suffer from a large loss in revenue.

- In this view, have countries tried to determine ex-ante the actual net benefits brought about by the implementation of incentives?
- When they offer incentives, governments incur a loss of revenue which will increase their deficit and possibly undermine the overall economic situation. Knowing that the economic situation is one of the major factors in the investment decision, is it possible that providing incentives may actually repel FDI?
- Have governments experienced an incentive competition between countries? Has this competition led to lower tax revenues for all countries involved?
- Incentives may be poorly implemented. In some cases, no company can benefit from automatic incentives as several barriers, mainly bureaucratic, block the process. In cases where only discretionary incentives apply, have countries experienced that the first investors tend to reap as much profit from the state as they can? When incentives are provided, do investors tend to ask for more?
- Has it been difficult for transition economies to remove incentives after they have been offered?

- What is the experience of transition economies regarding fraud such as fictitious foreign investment -- the establishment of front companies abroad in order to reinvest in their own country and benefit from additional incentives, rollover of business -- when a new corporation purchases assets of an existing operation in order to qualify for an incentive, or in the misuse of transfer pricing -- the transfer of profits from an operation that does not qualify for a tax holiday to a firm that does?
- Has the tax planning brought about by fiscal incentives been costly for the government? What monitoring systems exist?

Different levels of government can be involved in the design and the implementation of incentives. Nation-wide incentives are put into place by the state government and/or the parliament, region-specific incentives can be implemented by regional or local councils.

- In transition economies, are all incentives currently designed by the central government? What is the role of local authorities?

#### **IV. Effectiveness of financial vs. non-financial incentives**

Incentives can be financial or non-financial. The first category includes fiscal and non-fiscal measures, while the second comprises indirect cost reduction and preferential treatment. Most incentives in place in transition economies are relatively straight forward and concentrate on tax relief, whereas OECD Member countries seem to favour more complex non-fiscal measures.

Financial incentives reduce the direct cost of installation or of operation. The most frequently encountered fiscal incentives are: tax holidays, corporate tax and VAT relief, accelerated depreciation, customs duties exemptions and deductions of reinvested funds from taxable profits. Non-fiscal incentives are grants for employment, research and development, etc., loans, preferential access to foreign exchange, rebates and subsidies.

Financial incentives can also be used to compensate for deficient infrastructure. A potential investor might need container port facilities where such facilities are presently lacking. The government may simply not be able to build such a facility and might therefore lose the investment unless they provide “compensation” to the investor for having to construct his own facilities.

- Do potential investors tend to favour financial incentives, as compared to non-financial incentives, if so, why? What kind of financial incentive(s) do investors prefer, and why?
- How did investors obtain their incentive package? How do investors evaluate the benefits of financial incentives? Have financial incentives been a critical factor in the investment decision?
- Why do governments offer certain financial incentives and not others? What criteria are used to assess effectiveness in attracting FDI?
- What are the different types of tax holidays? What are the key elements and how are they implemented?
- Regarding non-fiscal incentives, to what type of activity, *e.g.* research and development or employment, are grants usually offered? Are grants less costly than tax holidays? How do governments determine the maximum amount granted to the investor?

Non-financial incentives do not provide direct financial compensation. They can be divided into two categories. Indirect cost incentives reduce or totally offset the indirect cost an investor has to bear. Examples are state-funded workers' training, housing facilities or infrastructure. Preferential treatment incentives discriminate in favour of the foreign investor in terms of market access or protection from domestic and/or foreign competition. Examples are government contracts, exclusive licensing or high tariff rates on a competitor's products.

- How do governments evaluate the cost of non-financial incentives? Are non-financial incentives more frequently discretionary? Is it more difficult to evaluate their actual cost?
- Are indirect cost incentives frequently provided in transition economies? Are they directed toward general infrastructure, thus with large spillovers, toward specific infrastructure benefiting only the investment project, or toward workers' training?
- Do indirect cost incentives improve a country's advantage in attracting foreign direct investment? What are the amounts spent by transition economies on indirect cost incentives?
- What type of preferential treatment incentives are provided in transition economies? Are there high customs duties or other disadvantages targeted toward a specific investor's competitor?
- What type of non-financial incentives do investors prefer, and why? How do investors obtain their incentive package? How do investors evaluate the benefits of non-financial incentives? Have non-financial incentives been a critical factor in their investment decision?

### Chapter 3

## INVESTMENT INCENTIVES, COSTS, BENEFITS AND IMPLICATIONS FOR POLICY

by

Rolf Jungnickel, Georg Koopmann  
Head of Research Group, HWWA Institute for Economic Research

### 1. Introduction: The potential of FDI

The locational structure of production is not only organised by “invisible hands” but also by government action and by investment strategies of internationally oriented firms. International investment by multinational enterprises (MNEs) has expanded rapidly in recent years. It was pushed by several factors (Härtel; Jungnickel; Keller 1996 forthcoming) the most important of which were and still are:

Modern information and communication technologies have fundamentally reduced the distance costs and increased the possibility to split up the production process and organise and coordinate it from a distance.

High and increasing costs of R&D and shorter product life-cycles call for a rapid and widespread -- *i.e.* international -- use of new developments.

New competitors, especially from the Far East, have entered the global market. This presses Western companies to cut costs by building international production networks and to advance into new markets in foreign countries.

The worldwide stock of FDI can now be estimated at about US\$2.5 trillion. Sales by foreign subsidiaries (which can be taken as a proxy of foreign production) are of the same order of magnitude as foreign trade. In most Western European high-income countries, foreign-owned affiliates account on average for over 20 per cent of manufacturing employment. In the services sector, foreign involvement is lower. However, with further liberalisation and privatisation and with ongoing technological progress, a certain catching-up can be expected.

After the opening-up for foreign investors, the Central and East European transformation countries (CEE countries) have registered a sharp increase of inward FDI although from a low level and with a certain disillusioning stagnation in 1993/4. The volume achieved falls short of earlier expectations. One explanation could be that, “in risky markets, the latecomer’s advantages are likely to be larger than the benefits to be earned by pioneer status” (Inotai 1992, p146). Even if one considers the low value of FDI as a consequence of undervalued currencies in the CEE countries, their share in the worldwide FDI stock is less than two per cent. Compared with Western Europe, CEE countries are clearly less integrated into the internationalisation of production brought about by MNEs

(for further evidence, see Stankovsky 1996a, pp.127). Hungary (along with small Estonia) is the only exception. It is internationalised by inward FDI to a similar extent as Austria. In the other three Visegrad countries where FDI is concentrated, less than 10 per cent of domestic capital formation is accounted for by Western MNEs. If one takes the average internationalisation of western countries as a yardstick, there obviously is a vast potential of internationally mobile investment to be attracted in the medium term.

However, from the experience of most other countries, we can learn that FDI rarely initiates economic dynamism. It rather follows and reinforces dynamism that was brought about by other, domestic or foreign, factors. The experience of FDI-led growth of some city states and small islands cannot be generalised. In particular, with regard to CEE countries, MNEs cannot be expected to eliminate political, administrative and legal restrictions and uncertainties which for their part form important impediments to FDI.

There are only a few studies assessing the macroeconomic contribution of FDI in the CEE countries;. They show a somewhat inconclusive picture (see Sheeby 1994; Hunya 1995; Stankovsky 1996a). In most but not all countries, there is a clear lead of foreign-owned firms in productivity and sales growth. However, their contribution to national economic growth is limited or it does not show up at all statistically. For the early 1990s, Stankovsky (1996a) finds that countries which could attract relatively much FDI (per head) show a below-average macroeconomic growth performance while high-growth countries (such as Slovakia and Poland ) received relatively little FDI so far. Currently, it seems that foreign investors are attracted by high growth rates rather than stimulating growth in the first place (Stankovsky 1996a). This would be in line with the above-mentioned international experience.

This is not to say that FDI cannot play a significant role in the restructuring process of the CEE countries (UNCTAD 1995). It can help create additional competitive jobs; the productivity advantage can be a basis for raising the overall income level; and it can bring new technologies and management know-how into the country and lead to a deeper and more balanced integration into the international division of labour with high income countries.

Data on the export performance of foreign subsidiaries support these propositions. More than one-fifth of the (864) foreign companies surveyed in Poland in 1995 have an export-to-sales ratio exceeding 75 per cent compared to less than 15 per cent of the firms surveyed in 1993 (PAIZ 1996). Companies like Fiat or ABB use Poland as single source for their European sales of individual products or as a springboard for expansion further east (Financial Times 28.3.1995) In Hungary, firms with foreign capital account for 70 per cent of the country's manufactured exports (Inotai 1996). This corresponds with high (frequently above 50 per cent) export shares in the total sales of foreign affiliates which to a large extent are controlled by a small number of multinational corporations like General Motors, General Electric, Ford, and Siemens (The Prague Post 7.-13.6.1995). The relatively strong export performance of foreign-owned companies in CEE countries is extensively discussed in studies by UNCTAD (1995a) and UNECE (1994). It is based on their superior productivity compared to domestic firms and on their integration into the MNEs' production and marketing networks.

From this, we can conclude that MNEs can play a significant role for the economic development in the CEE countries. However, the large potential of FDI for raising the income level in the host country and the increased mobility of investment in itself are no compelling reasons for granting incentives. Instead, incentives policy should reflect the supplementary role of foreign companies

reinforcing domestically-induced growth processes, and it should be based on more specific considerations concerning the contribution of FDI to economic development.

## **2. Why incentives to FDI?**

An incentive policy has to be justified by inducing investment which is good for the economy and would not have come about without the incentives. In neo-classical models with perfectly functioning markets, there is no room for investment incentives. They would lead to distortions of prices and competition and hence to losses of national welfare. However, this simple view has changed with the spread of “new growth theories” and “new foreign trade theories” during the past 10 to 15 years. These lines of thought are more realistic as they take into account market failure and oligopolistic competition with scale economies, often as a result of externalities in agglomerations of economic activity. On the basis of this “new” theoretical thinking (which is not as new as it often maintained) governing institutions often deduce a greater role to compensate market failure and thereby increase national welfare. In particular, it can be rational for governments to engage in the promotion of R&D and in the building-up of agglomerations of economic activity where the firms can profit from technical scale economies and externalities of other firms.

There are basically three lines of argument in favour of investment incentives.

### ***1. Compensation for externalities***

- Companies invest in foreign countries in order to strengthen their market position and to make profits, at least in the long run. However, the investors often cannot appropriate the entire benefits brought to the country. They produce positive externalities to other parts of the economy:
- Other companies may profit from the foreign investor’s investment in human capital when they hire workers trained by the foreign investor.
- Foreign-owned companies using modern technologies and management know-how can serve as show-pieces, furthermore, indigenous firms can get access to this knowledge by poaching the investor’s specialists.
- Transfer of technology and other know-how also takes place within normal supplier relationship, *e.g.* when local suppliers have to improve their quality in order to meet high standards of the foreign investor.
- One important area of spillovers is the opening-up of foreign markets for the investor’s local suppliers.
- There can thus be a wedge between the private returns of an investment and the social benefits to the host economy (UNCTAD 1995). This would lead to less FDI than would socially be desirable. Incentives could then induce foreign firms to invest more capital, give more training to the workforce, or employ new technologies on a larger scale than would have been profitable were there no incentives. Incentives are the price paid by the host country society for additional activities. (However, it may be pointed out here already, that FDI which benefited from incentives cannot automatically be considered “additional” in the sense that it would not have been undertaken were there no incentives. Furthermore, additional investment

does not necessarily lead to positive external effects. There can as well be negative externalities.)

## 2. *Compensation for locational disincentives*

- This argument cannot be considered a general one in favour of investment incentives. It can be justified only on conditions:
- Because of locational disadvantages, *e.g.* poor infrastructure, inefficient administration, or high costs for business services, FDI would be unprofitable and hence would not take place.
- Domestic resources (*e.g.* workforce) would be used less efficiently or not be used at all in a situation with no FDI. In the case of unemployment, greenfield FDI could bring in jobs and income, takeovers of inefficient domestic producers could lead to restructuring and productivity increases and re-establish competitiveness.
- In the medium term, profitability can be achieved of the subsidised investment in order to avoid business failures induced by government action.
- As far as the international sector of the economy is concerned, compensation is given only in those fields of activity (sectors) where there can be achieved a *comparative* advantage in international competition; otherwise, devaluation would be more efficient.
- The temporary compensation for locational disadvantages is based on similar thoughts (or hopes) as the classical infant industry argument. Subsidised investment can help to create structures where technical scale economies and economies of agglomeration can be realised. A subsidised movement on the learning curve can bring down unit costs. After the first investors are attracted by incentives, the following ones can profit from externalities and no more incentives are needed.
- Besides the above-mentioned arguments for temporary incentives, there may be some justification for general compensation of foreign investors if they bear specific costs on behalf of the society or if they are especially affected by general-purpose government regulations (UNCTAD 1995).

## 3. *Countervailing measures to other countries' incentives*

- When investments are increasingly mobile internationally, and locational conditions are not too different, out-competing of other countries may be rational as long as the costs of incentives are lower than the social benefits expected from the investment. Locational competition drives up the level of incentives and hence leads to a rent-shifting from the finally chosen host country to the investor. The aforementioned wedge between private and social benefits represents the maximum cost the winning country can incur without losing money (UNCTAD 1995). Then, the country, taken as a whole, would receive no benefit from the investment. The expected positive external effects would be paid for in full to the foreign investor.
- In order to avoid bidding up incentives to the point where no net benefit from FDI is left to the “successful” host country, the competing countries could agree to limit the amount of money spent. However, this will be feasible only if a fair inter-country sharing of the benefits from FDI could be expected. This seems realistic in the case of high FDI growth and many

investors. If merely one big project is at stake, sharing would require setting up some redistribution mechanism, which seems highly unlikely.

- The countries bidding for internationally mobile investment are in a sort of prisoner's dilemma: They could be better off if they restricted the degree of incentives, but when it comes to the choice of an investment location, it is rational to enter the bidding.
- All in all, there is -- in economic terms -- a clear case for investment incentives. These are to be considered an element of "normal" economic policy which aims at increasing national employment and income levels. However, it is also clear from the foregoing that there are conditions to be observed if international incentives are to bring about welfare gains. Incentives have their costs which have to be put against the expected benefits. Both are hard to assess. Furthermore, it has to be taken into account that FDI which was located in a country only because of high incentives will be especially sensitive to higher incentives which may be given elsewhere, later on. A policy-oriented evaluation should take into account differences in the working of incentives as to the kind of incentive and investment.

### **3. The working of incentives**

Investment incentives are used to attract, or retain, FDI (and domestic investment) in often intense competition among governments. With trade and investment barriers declining, the number and range of incentives available for investors has augmented considerably since the mid-1980s, as has the number of countries that offer incentives. More than 1000 agencies have been estimated to exist in Europe which have as their sole or key objective the attraction of inward investment (Ernst & Young, quoted in Financial Times 24.10.1995), even though systematic comparable figures on the number, type and value of FDI incentives offered by national governments and subnational authorities are not available (Unctad 1995, p. 45). Concurrently, the characteristics of incentives policies have been changing. Governments less often provide investment incentives automatically (upon compliance with certain qualifying conditions) or in general irrespective of the region, sector or activity in the country where the investment is to take place. Instead, incentives are increasingly designed to support specific projects, priority industries and objectives, and more often than not they come as part of a package of inducements and commitments which are negotiated exclusively with individual foreign investors on a case-by-case basis. This is particularly true when large projects and investors or advanced technologies are involved. Altogether, though, incentives that are directed to domestic and foreign investors alike, not discriminating between the two groups in design or implementation, still constitute the large majority of incentive programs. The tendencies observed in general by and large also hold for incentive measures adopted in CEE countries persisting significant differences in investment policies, *e.g.* between the Czech Republic and Hungary, notwithstanding (Zemplerova's paper).

Prime objectives of present incentive schemes, frequently in a regional and sectoral context, are the creation of employment and skills, export promotion and technological development, and the inducement of "linkage externalities" (Krugman) with upstream and downstream industries. For these purposes, financial as well as non-financial incentive measures are employed. In a growing number of cases they are made contingent on a specific conduct involving minimum levels of activity for the investor to achieve. The use of such conditional incentives has meanwhile been restrained in the Uruguay Round of trade negotiations. According to the Agreement on Subsidies and Countervailing Measures, those subsidies that are linked to the fulfilment of local content (*i.e.* the use of domestic

over imported goods) and export performance requirements will no longer be allowed. CEE countries must phase out existing measures of this kind by the year 2001 (Article 29 of the Agreement).

### ***Financial incentives***

Financial (or pecuniary) incentives comprise fiscal and non-fiscal devices, whereas non-financial (or non-pecuniary) measures can be subdivided into:

- indirect cost incentives such as state-funded workers' training or infrastructure (general or specific), and
- preferential treatment incentives such as government contracts, exclusive licensing or high tariff rates on a competitor's products.

Fiscal incentives, which continue to be the most widely used type of FDI incentive, basically consist of *reductions* or *exemptions* regarding corporate income and other taxes as well as social security contributions and import duties. Tax *stabilisation* schemes that safeguard the investor against the changes of fiscal regimes also assume growing importance. In CEE countries, and in developing economies, these tax related measures are more common than other financial incentives. Most countries in Central and Eastern Europe in particular offer reductions of the standard income tax rate and tax holidays to foreign investors. In Western industrial countries, by contrast, the provision of non-fiscal financial support prevails of which cash grants, subsidised loans and loan guarantees, government equity participation and insurance at preferential rates, *e.g.* against exchange-rate volatility, are the most popular forms. These measures are most often earmarked to the assistance of economically disadvantaged regions. In recent years, the use of non-fiscal financial incentives has increased in CEE (and developing) countries, too (Unctad 1995, p. 16).

### ***Export oriented FDI***

Fiscal advantages, especially tax holidays and tariff privileges, together with regulatory relief and the provision of prepared industrial sites and ready facilities in special economic zones, are a typical package of incentives targeted at *export development*. Building export platforms is indeed the principal objective of incentive policies in many emerging economies. In order to avoid multilateral constraints on the granting of direct export subsidies, export incentives at the border often are provided in the more indirect form of duty drawbacks or duty remission schemes for imported raw materials, parts and components and capital goods used in production for export. Possible external effects that might justify export-related investment incentives, in addition to the creation of jobs and foreign exchange, derive from scale economies, information costs, quality standards and the maintenance of market share and reputation associated with this type of foreign investment (Unctad 1995, p. 26).

Export-oriented FDI is on the rise globally and in Central and Eastern Europe as well even though foreign investment in this region -- and elsewhere --, according to a recent OECD survey (OECD 1994) is still primarily driven by access to the host-country market (44 percent) and the share (26 percent) and potential (11 percent) of this market as against low production costs. These findings are confirmed by other surveys (Stankovsky 1996; EBRD 1994). However, in Poland, for instance, factor-seeking FDI, looking for low-cost qualified labour in particular, now seemingly dominates market-seeking investment as two comparable surveys conducted in 1993 and 1995 suggest

(PAIZ 1996). Between the two surveys, the importance of labour cost and supply increased substantially whereas market-related investment determinants gained only slightly (size of the market) or even lost in importance (growth potential). Obviously, FDI increasingly plays a role in the development of competitive advantages UNCTAD 1995a).

By its very nature, export-oriented FDI is more mobile (“footloose”) than investment oriented towards the domestic market. It is increasingly linked to related parts of global company networks but not tied for market reasons to a particular country. In consequence, the inducements awarded to such engagements in one country often compete intensely with incentives available in other locations that are equally suitable for the project. As the profits earned with the investment are mobile as well, the host country's share in the value-added of the project could fall short of the revenue loss (or its equivalent) suffered by the government in granting the incentive package. The risk that this may happen is increased when the social opportunity costs of the local resources used by the foreign investor are significant because alternative opportunities for gainful employment exist.

### ***Technology-oriented FDI***

International incentives competition is also strong in *technology-intensive* industries which are chiefly characterised by above-average R&D expenditures and innovation efforts. Like export-oriented FDI in more traditional, less innovative sectors, FDI in high-technology is frequently rather factor-seeking than market-seeking and highly mobile among countries. At stake is high value-added investment that may include the establishment of local R&D facilities. Since it typically involves the transfer and diffusion of technical knowledge, as well as extensive training of the local workforce, technology-intensive FDI creates far more positive externalities for the host economy than other FDI normally does. The incentives offered by governments therefore tend to be particularly generous in this area (Lamparter 1996).

Multilateral agreements impose little discipline on governments wishing to support private research activities. Up to 75 per cent of basic industrial research and 50 per cent of pre-competitive development may be funded by public money without fear of retaliation by trading partners. In addition to this, Central and East European member countries of the World Trade Organisation (WTO) were granted extra leeway in the Uruguay Round to promote technology-intensive -- and other -- industries. For a period of seven years, beginning in 1995, virtually any kind of subsidy programmes adopted by these countries -- and transition countries in general -- has been immunised (“greenlighted”) against challenges by other WTO member countries (Article 29 of the Agreement on Subsidies and Countervailing Measures). Hence, at least in the medium term, CEE countries enjoy an almost unlimited freedom to subsidise in the race for technology-intensive FDI (and thereby give away an increasing part of the positive externalities).

Available evidence confirms the growing importance of innovation and R&D among the activities targeted by investment incentives. In *Western Europe*, the decision to offer investment incentives increasingly relies on criteria such as the technology content of the package provided by the foreign company, the transfer of company know-how to suppliers and individuals in the host country and the implementation of research activities on the spot which in most cases involves the development of new products or the adjustment of existing ones to local conditions (Van Hervaarden 1995). In a growing number of *developing countries*, science and technology parks arise that offer low-cost infrastructure and services such as satellite communication and transport facilities, often in conjunction with substantial tax benefits and subsidised land, specifically to investors in

industries like electronics, information technology, telecommunications and software development. The Information Technology Park which is under construction in Bangalore (India) is one of the most recent examples (NFA 17.5.1996). Among the *CEE countries*, Hungary has attracted sizeable corporate research facilities as a number of multinational corporations (GE-Tungsram, Electrolux, Knorr-Bremse) have relocated part or all of their European R&D activities into that country (Inotai 1996).

The incentives provided to technology-based investment projects in competition with other countries could nonetheless be too high a price for the benefits reaped by the host economy. A net economic loss could accrue, for instance, if complementary local resources were insufficient for the diffusion of technology, and hence the expected positive externalities fail to fully materialise. In this case, economic policy would have to follow a different course stressing local resource development.

### ***Domestic market oriented FDI***

Incentives rivalry between governments is less relevant when *domestic markets* are the main asset of countries seeking FDI. If the affected sectors are not exposed to international competition, as it happens with non-tradable services or goods shielded by natural trade barriers such as high transport (relative to production) costs, the role of incentive policies is limited. The more important case concerns industries that compete with imports. In these industries, trade-protective measures or “commodity” incentives (affecting chiefly output prices) presently are often the main category of incentives granted. They include both the imposition of extra tariffs on the final product (and reduced rates on imported inputs) protecting the investor's local production against import competition (“tailor-made” protection from imports), and the concession of preferential duties on other (imported) products of the investing company. However, the management of trade flows to the advantage of individual investors is increasingly constrained through international regulations in the WTO framework and more particularly through the Europe Agreements between CEE countries and the European Union (EU).

Effective trade protection is frequently complemented by the provision of generous financial advantages or “factor” incentives (affecting the cost of land, labour and capital) to the foreign investor. A case in point is the “mega deal” between Volkswagen and Skoda (constituting about one-fourth of total FDI in the Czech Republic. Cf. *The Prague Post* 7.-13 June 1995) where maintenance of high tariffs on imports of passenger cars for four years was coupled with the granting of tax holidays. When the policy is more specifically to lure foreign investors into certain regions of a country, financial incentives tend to be the dominant part of the package offered. The current debate on proposed massive tax breaks for General Motors in the south west of Poland, and possible “matching” concessions to be awarded to other car manufacturers in the country (Fiat, Daewoo), meanwhile points to the limits and ambiguities of a policy of fiscal generosity (Financial Times 25.4.1996).

A positive impact of incentives for market-oriented FDI on the volume of investment does not necessarily lead to welfare benefits for the host economy. The allocative distortions caused by incentives are most distinct if trade-protective devices are adopted. In this case, consumer or user costs (via increased prices) are added to the producer inefficiencies associated with any kind of state intervention that goes beyond the mere correction of market failures. The positive externalities most relevant in the context of market-oriented FDI relate to labour training, *i.e.* the upgrading of skills of mobile workers, and the creation of backward linkages involving agglomeration economies,

technology transfer, etc. From a dynamic viewpoint, an infant-industry argument could also apply with gains arising over time from declining unit costs and learning-by-doing. Foreign investors could build dynamic comparative advantages, reshaping existing patterns of competitive strength, and eventually turn protection-dependent investment projects into internationally competitive assets. They might, however, also use their bargaining strength and market power to preserve protection from import competition (and local market entry of competitors) and inhibit dynamic comparative advantage to the economic detriment of host countries. A number of cases involving negotiations between CEE country governments and large foreign investors suggest that this might actually happen (Stankowsky 1996, p. 134 and Zemlinerova-Paper, p. 4).

#### **4. Counting costs and benefits**

The impact of incentives on the volume (and quality) of foreign investment and hence the resulting economic effects in the host economy presumably vary, among others, with the form of incentives granted and the type of investment envisaged, even though hard evidence is difficult to come by in this respect. Existing empirical surveys concentrate on the role of investment incentives in general. While pointing to the allocative distortions caused by these measures, the studies tend to de-emphasise their significance at the company level. In the established hierarchy of investment motives, incentives consistently rank far below core FDI determinants like market and resource/factor-seeking or economic and political stability and the regulatory framework. They are typically regarded as “sweeteners” or “icing on the cake” with marginal impact at best. “The two most important considerations for companies choosing where to site a new manufacturing plant are, first, access to the market they wish to serve and, second the cost and flexibility of labour. The issues of grants and incentives come lower on the list of priorities” even though “a cut-throat game of poker is often played in which big companies may use their international clout to win higher grants and other concessions” (Financial Times 24.10.1995).

The key question in the present context -- whether the gains from incentives exceed the costs -- remains unresolved in the available investigations. To some extent, this may be because “too many judgements about incentives come from a priori reasoning and not enough from careful analysis of what investors actually do” (Guisinger 1992, p. 119). As researchers employ different standards in defining incentives and measuring effectiveness, their findings are also hard to compare. Different concepts of effectiveness, in particular, abound (Guisinger 1992, p. 117f.). Effectiveness is alternatively depicted as

**absolute effectiveness:** a change in incentives leading to a change in investment levels;

**relative effectiveness, version one:** the benefits of incentives exceeding their costs ;

**relative effectiveness, version two:** incentives achieving the goal better than other policy instruments ;

**time-bound effectiveness:** changing impact of incentives over time ;

**conditional effectiveness:** incentives effective only under certain conditions;

Even if incentives are marginal, they are not necessarily ineffective in specific cases in either of the meanings of effectiveness noted. A marginal impact may indeed be crucial if it operates to tip the balance in favour of a specific country.

The concepts of absolute and relative effectiveness appear to be useful devices framing the discussion of costs and benefits connected with investment incentives. Incentives are obviously of no use for the host country if they fail to prompt additional investment flows or to stimulate specific activities of companies from abroad in fields like exporting, professional training, R&D or cooperation with local firms and institutions that would otherwise not, or to a lower extent, have taken place. In this case, the granting of incentives would just lead to a loss of public revenue/increase of public expenditures (if financial support is provided) or to reduced competition and a distortion of allocation (if trade-protective measures were applied) in the domestic economy while the foreign investor and -- in the case of joint ventures -- even indigenous firms would receive "free" money in one form or another that renders a higher rate of return possible. In terms of strategic trade theory, "rent shifting" would occur.

Empirical research has been unable so far to establish in a rigorous manner to what extent investment incentives have been redundant in the above sense. This is, first, because the actual amount of incentives is difficult to determine given the variety of more or less quantifiable devices applied. Secondly, a true measure of incentives would also have to account for existing disincentives to investment but no widely accepted yardstick for measuring the incentives value net of the value of disincentives is available that could be used in the investment field in a similar way as the effective rate of tariff protection is used in the trade field. Finally, and most important, actual and counterfactual evidence must be compared, *i.e.* (observed) investment behaviour in the presence of incentives with (conjectural) behaviour in their absence. However, as Guisinger (1987, p. 221) puts it, "it has so far been impossible to take before and after snapshots of investment behaviours", which is mostly due to the "complexity of netting out the effects of the dozen or more policy instruments that affect the typical investment."

Even so, the impact of investment incentives on the volume of investment is probably stronger than most empirical surveys seem to suggest though not as strong as investment promotion agencies would make one believe. One reason is that investors would understandably tend not to mention incentives as a significant factor in site selection when countries offer roughly similar incentive levels. With competition among countries driving the level of incentives even higher, their importance would correspondingly grow. This is particularly so when export-oriented (factor-seeking) investment projects are at stake and the investor may choose between different locations within the same world region where other (than incentives) policies and non-policy conditions converge.

With regard to the (absolute) effectiveness of individual incentive measures, tax breaks on corporate income seem to make the least difference. They are apparently by themselves not able to overcome negative economic, legal and policy factors. Nor have they been successful in attracting major capital-intensive projects, as such projects typically have losses during the start-up operations and thus cannot benefit from tax holidays (Sporken 1995, p. 320f.). The most important tax relief for companies considering potential investments seems to be relief from customs duties on imported capital equipment. This is suggested by the experience of Asian countries (Sporken 1995, p. 321). As regards automatic versus discretionary incentives, the latter category looks better suited to ensure that the investment taking place has an element of additionality (Summary of Foley's paper).

Given that incentives have a significant positive effect (excessive incentives might effectively deter investment by creating a negative country image) in that the volume of investment increases sizeably, a net welfare benefit for the host country can nevertheless not be taken for granted. Investment Boards would naturally tend to regard the volume effect as a measure of success and most important criterium. This would also be correct from the viewpoint of an individual region within a host country that receives the investment without paying for it. But for the host country as a whole, the costs of the incentive measures (for both successful and failed projects) must be weighed against the benefits of the effected investments. Both are hard to quantify and compare.

Even if the economic costs of the incentives measures themselves are disregarded for a moment, a positive welfare effect of inward FDI is less than self-evident. It depends on the circumstances of the case at hand. When the investment is of the strategic-asset seeking type (Dunning 1995) and/or economic and social institutions in the host country are relatively weak and markets function imperfectly, as seems to be still the case in a number of CEE countries, “there can be no presumption that the activities of foreign companies will automatically contribute to a more efficient use of resources” (ECE 1995, p. 14f.). Rather, domestic rivals, consumers and user industries could be harmed as competition is restrained. These costs would add to the incentives cost proper.

The case is more complicated when foreign investment, as happens most often, confers real economic benefits to the host country, in terms of jobs, training, know-how, export promotion, technological innovation, creation of dynamic comparative advantages, scale and agglomeration economies, etc., that may or may not be worth the costs associated with the incentives provided. A key notion in this context is the concept of opportunity costs. It accounts for the benefits that an alternative use of the resources employed by the government and the investor would have entailed.

In the case of financial incentives, it can realistically be assumed that the government-related opportunity costs are largely identical with the amount of money actually spent (or foregone), since an alternative investment of the funds would hardly yield a return higher than the going market interest rate. The opportunity costs, still government-related, of non-financial incentives are more difficult to define and almost impossible to measure. They are basically the benefits of a less distorted economy foregone. However, in a second best world where costs and prices are distorted anyway, and government failure could be worse than market failure, the difference between the two states of distortion is hard to determine.

The more important part of the opportunity costs may concern the local resources used (and enhanced) by the foreign subsidiaries. In the absence of incentives and related investor activities, these resources would normally earn a lower income (or no income at all). If they had been unemployed and dependent on the granting of social benefits, for instance, incentives might be justified up to the amount of these transfer payments avoided. They might even exceed this limit if possible significant improvements of local resources are considered that would not have happened in the non-incentives anti-monde. Again, very difficult problems of measurement and judgement are involved.

Incentive measures must also be compared to other policies that have an impact on investment flows. By definition, “incentives include any measurable economic advantage afforded to specific enterprises or categories of enterprise by (or at the direction of) a government, in order to encourage them to behave in a certain manner” (Unctad 1995, p. 4). In consequence, they tend to reduce the costs, or increase the return, of doing business in a way that distorts price and cost structures to a higher degree than general supply-side policies would do. A uniform reduction of the standard corporate tax rate, for instance, is less distorting than a tax break or the granting of financial or non-

financial incentives in general. But the latter could be more effective in attracting beneficial foreign investment to an extent that more than offsets the economic costs of the distortions caused. Whether this happens can only be established on a case-by-case basis.

## 5. Policy implications

The foregoing analysis has shown that there is a case for investment incentives. Incentives can compensate for positive externalities and existing disincentives in the host country, or they can be countervailing action in the international competition for mobile investment. While it is hardly possible to generally discriminate between “good” and “bad” incentives and to design an optimal incentives system that maximises benefits with least costs, some policy conclusions can be drawn:

1. Expectations as to the contribution of FDI to national economic welfare should be cautious. FDI will normally be a complementary factor, incentives will not make it play the main role in the growth process. National policy should more often consider “no-incentive strategies” as it is practised in some CEE countries.
2. For the attraction of FDI it is of overriding importance to create an open attitude towards foreign investors and liberal business conditions. Transparency in administrative procedures and liberalisation of flows of investment capital, loans and profits reduce considerably the uncertainty and hence the investment risks that foreign firms are exposed to.
3. Privatisation policy plays an important role in this context. The engagement of foreign investors in “strategic” sectors such as finance and public utilities can be considered a sign of openness towards foreign capital. If former state monopolies are broken up into competing entities, and if foreign investors are allowed to engage, efficient competitive structures can be expected to develop. The risk that state monopolies are succeeded by private ones is avoided.
4. Incentive policy should aim at following some basic principles:
  - No discrimination of domestic investors and of investors from specific countries.
  - Transparency of costs and benefits for both the investor and the country; this includes transparency of costs and benefits to consumers, other policy areas and industrial users of the products in question.
  - Incentives should be linked as close as possible to the activity which is desired or expected from FDI (*i.e.* to new investment, performance of R&D, etc.) in order to exclude windfall profits and to use tax money efficiently.
5. These principles are hard to follow individually, and they can be conflicting. Specific incentives for individual investors may be in contrast to the national treatment principle and to the interest of those firms that are not subsidised. Governing institutions have to compromise when developing their FDI strategy. They have to take into account that “non financial” incentives also have their financial implication, both on the costs and benefit sides.
6. Fewer and less specific incentives reduce the distortion of competition and make it easier to assess the costs of a project. However, such a policy provokes windfall profits of firms

which would have invested anyway. “The more targeted an incentive, the greater its impact -- but also the greater the chance that it leads to biases and distortions that impose economic costs on the economy” (UNCTAD 1995, p.35). Even if incentives are tailor-made for individual projects, the risk cannot be avoided that the subsidised firms have a free ride. Targeted incentives policy not only has to solve the problem of picking the winning sector, it also has to pick a winning company. This is an extremely uncertain business, as many examples of failed privatisation in East Germany and elsewhere have shown. Governing institutions are thus facing a dilemma when they decide how to allocate their budgets for incentives.

7. General tax holidays more often than not violate the principle of binding incentives to the function expected. Tax exemptions should, therefore, not be granted generally. They should rather be bound to new investment in fixed assets, R&D or human capital. Similarly, specific customs privileges or individual protection from import competition are inferior to direct subsidies, which also would make the costs of investment incentives more transparent.
8. From the severe problems to identify and quantify costs and benefits of investment incentives and from the conflicting interests involved, the conclusion that the level of incentives should be driven down can be drawn. At least, there should be a maximum level of subsidies per job created and a gradual phasing out in the medium term. CEE countries should rather put their money and efforts in streamlining the investment procedures and in the elimination of obstacles to foreign (and domestic) investment. A case for restrictions also follows from the fact that FDI which is located in a country only because of high incentives will be especially sensitive to higher incentives which may be given elsewhere later.
9. A reduction of investment incentives can be achieved in an easier way if international agreements on binding rules for the race for FDI are concluded. The most effective way to handle this problem seems to be cooperation among the core CEE states since they are immediate competitors for mobile investment. The most appropriate option to organise binding limits on incentives appears to be within the framework of the treaties with the EU so that the CEE countries could join the EU-wide state aid control system.



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## Chapter 4

### INVESTMENT INCENTIVES AND SUBSIDIES

by

M. Foley

Projects Director, Irish Development Agency

#### 1. Introduction

The contents of this paper deal mainly with investment in manufacturing, as investment in this area involves an assessment of a greater number of factors than are associated with other investment categories such as land or property. Manufacturing investment tends to fall into two categories:

1.1 Mobile Investment

1.2 Location Specific Investment

##### *1.1 Mobile investment*

Mobile investment, by its name implies that it is not tied to any specific location. The product or service involved may be supplied from a wide variety of locations, and the incentives on offer in each one of these locations may be important factors in determining the eventual choice of location. Competition for such investment is frequently very intense, and a small number of locations may be assessed as being equally suitable for the investment. At that stage the decision to invest may be made on a seemingly trivial criterion, such as the working relationship that has been established between the investor and the representatives of the various investment locations.

##### *1.2 Location specific investment*

The mobility of this type of investment is much more restricted than mobile investment. In this category, there is usually one main criterion, and a number of subsidiary criteria which influence the investment decision. An example of a main criterion would be the availability of raw material or feedstock supply. Another example of a main criterion would be market access, such as Japanese and American investment endeavouring to penetrate the European market. Market proximity would be another example, this would apply to heavy or bulky goods which would cause a project to be sensitive to transportation costs or goods with a short shelf life, such as dairy products, which are sensitive to transportation times.

Projects which are location specific, are not as sensitive to financial incentives as mobile projects. The competition for location specific projects only exists between the locations which have

the specific criterion that the investor is seeking. Naturally, the lower the number of locations with the specific criterion, the less will be the need to offer attractive financial incentives.

## **2. Investment subsidies and incentives / rationale**

There are two main parties with a vested interest in investment subsidies and incentives. They are:

- 2.1 the host country which is offering the incentives and subsidies; and
- 2.2 the investor which the host country is endeavouring to attract.

Both of these parties have a different perspective.

### ***2.1 The host country perspective***

A host country or region would offer financial incentives for the following main reasons:

- as a vehicle for the reversal of economic decline;
- to provide a 'level playing field' where the host country or region perceives itself to be
- at a disadvantage in comparison to its main competitors;
- to generate government revenues through increased taxation;
- to increase economic activity by strengthening the spending power of the
- community;
- to introduce new skills and technology into the community;
- to increase export of goods out of the region.

### ***2.2 Investors perspective***

When compiling a list of potential investment locations, an investor will first select those which seem to have long term profitable potential. If the investor is satisfied with his review of the long term business environment, he will then examine the package of incentives, which is on offer. Normally an investor will view the existence of financial incentives in a favourable light. In many cases an investor will not include a location on the shortlist unless it is offering financial incentives. Occasionally the incentive on offer may be the deciding factor in selecting the specific location, but even where this may not be the case, the existence of the incentives would be taken as evidence by the investor that the authorities are favourably disposed towards foreign investment.

Occasionally the existence of financial incentives may be viewed negatively. The investor may view their existence as evidence that there are perceived weaknesses or deficiencies associated with that region as an investment location.

### 3. The role of the European Commission

As already stated, financial incentives are viewed with a different perspective, from the investors viewpoint, and from the host country or region viewpoint. There is however a third perspective, which has an important impact on subsidies and incentives within the European market, and that is the view of the European Commission. The Commission has two distinct roles in relation to incentives for investment:

- **It provides grants and loans to stimulate investment.**
- **It acts as a co-ordinator and controller among member states to prevent unfair competition among its members.**

The Commission offers incentives in five main areas:

- Infrastructure & Economic Development
- Agriculture & Fisheries Support
- Education & Training
- Research & Development
- Special Initiatives

#### *Infrastructure and economic development*

Contributions under this heading are provided in the form of 'structural funds'. These funds are paid directly to public authorities in member states, for specific infrastructure projects. For each project the member state must contribute an amount equal to that which has been granted by the Commission.

The Commission also provides low-interest loans to the private sector in member states. Eligible projects must create a minimum of two jobs in designated geographic areas. Such projects may be entitled to up to 50 per cent of the project costs at interest rates substantially lower than commercial rates.

The Commission also supervises programmes of state-aid provided by member governments to the private sector. It will only allow state-aid up to a level which it considers necessary to offset disadvantages within a specific region. Certain regions within the community are awarded what is called 'assisted area status'. These areas are entitled to government grants, and the Commission will decide the level of grant which can be paid in the areas. The grant levels are defined as a percentage of capital expenditure. The size of the percentage is estimated as that which is required to overcome the perceived disadvantage of the region in question. The percentage of grant therefore is entitled the 'Net Grant Equivalent' or N.G.E. The grants specifically apply to capital expenditure, and grants for revenue expenditure such as training are not normally included in limit calculations.

The following chart outlines the basis on which the N.G.E. limits currently apply in each of the member States. In the column 'Total Assisted Area' the figures given state the percentage of that countries population living in the designated areas, and the column 'Maximum EU Aid Ceiling' specifies the grant level expressed as a percentage of the capital investment, which can be paid in the designated area in the specified country.

### Details of Net Grant Equivalent (NGE) limits currently operating

Country	Population coverage %(1)	Max European Union aid ceiling % (2)
Belgium	33	30
Denmark	20	25
France	42	25
Germany	42.8	23
Greece	100	75
Ireland	100	75
Italy	49	65
Luxembourg	80	25
Netherlands	16.6	25
Portugal	100	75
Spain	58.3	75
United Kingdom		
Great Britain	34	30
Northern Ireland	100	75

1 Expressed as a percentage of national population

2 Net Grant Equivalent (NGE): the maximum grant (after tax) permitted as a percentage of capital expenditure. NGE limits may be lower in certain parts of the assisted areas.

Source: Author.

#### 4. Foreign direct investment decision making factors

A foreign investor decision will be influenced by a variety of factors. Many of these factors will arise as a result of inherent characteristics of the sector, the project and many others will exist as a result of inherent characteristics of the investor. The final decision will be made as a result of an assessment of many factors, and the weighting given to each factor will vary from project to project. The decision in relation to each project will be determined by a unique and specific combination and weighting of factors which are unique to that particular project.

In a recent survey, investors were requested to rate the importance of 22 investment factors. The results of this survey, which are given below, provide some surprising results.

#### Annual investment intentions survey 1995

Factor	Score	Factor	Score
Access to trade blocs	1.4	Government Attitude	2.2
Energy Costs	2.2	Availability of local partners	2.2
Overall level of taxation	2.2	Currency Stability	2.3
Telecommunications	2.3	Road Links	2.4
Train Links	2.4	Political Risk	2.5 (2.9)
Access to Suppliers	2.5	Labour Costs	2.6
Land Costs	2.6 (2.5)	Incentives	2.7
Skills	2.7 (2.8)		

Score is average which holds for both developed and developing locations unless figure appears in brackets. In this case first figure is for developing location, second is for developed.

1 = crucial; 2 = important; 3 = of some importance; 4 = unimportant

Source: Author.

## **Incentives**

Factor	Score
Tax Holidays	2.2
Corporation Tax Rate	2.5
Cheap Land	2.6
Soft Loans	2.7
Grants for plant and equipment	2.7
Regional Grants	2.8
R & D Grants	2.8
Training Grants	3.0

Score is average which holds for developed and developing locations.

1 = crucial; 2 = important; 3 = of some importance; 4 = unimportant

Source: Author.

## **Dissuasive Factors:**

Factor	Score
Low Productivity	2.6
High Level of Strikes	2.7
High Rate of Unionisation	2.8
Corruption	3.0
Bureaucracy	3.1
Low quality development agency staff	3.3

Score is average which holds for developed and developing locations.

1 = unacceptable; 2 = problem; 3 = of some importance; 4 = unimportant

Source: Author.

It is interesting to note that market access is the main criterion in selecting a location, while moral issues, such as human rights, are of virtually no importance. Corporate tax holidays and the rate of corporate tax is also important, while corruption and bureaucracy would not be considered deterrents. (This latter point may be of interest to many of the Newly Independent States). It is also interesting to note that the investor does not perceive a development agency as an important factor in his decision. While this may be the case from the perspective of the investor, there is more than ample evidence to suggest that countries or regions with a good development agency are substantially more successful in attracting investment than those areas which do not have such agencies.

## **5. Inter-state comparison**

Before comparing the incentive packages available in various states or regions, it is necessary to clarify some definitions. The factors which influence an investors decision would normally fall under two categories:

### **1. Financial/fiscal incentives**

## **2. Non financial incentives**

It is now proposed to differentiate between those two major headings, and to clarify by giving some examples of each.

The most common form of incentive is the fiscal incentive, involving tax breaks, tax holidays, reduced import or export duties and similar measures. Fiscal incentives are preferred by developing countries, particularly in Asia, Africa and Eastern Europe. Financial incentives meanwhile, are commonly offered in Western Europe and USA and include grants for capital expenditure, training, site or infrastructure development and soft loans.

There is also a third category consisting mainly of subsidies which may include anything from cheap land deals, infrastructure developments, assistance with recruitment, etc.

There are two categories of financial incentives:

- a) Automatic*
- b) Discretionary*

### *a) Automatic incentives*

As the name implies, these incentives are paid to all projects which fulfil standard grant criteria. They are simple to administer but, because of their 'blanket' nature, they are paid to projects that would have gone ahead even if the incentives were not available. Few countries in Europe now operate automatic incentives, with the exception of Italy and the Netherlands. In those countries where automatic systems operate, the amount of grant paid will be in accordance with published formula with very little variation emerging as a result of judgement or discussions with the relevant grant giving authorities.

### *b) Discretionary incentives*

In the case of discretionary incentives, the amount of assistance is not fixed. Applicants for discretionary grants generally have to show a need for grant assistance. It will be essential for the applicant to demonstrate that it is unlikely that the project will proceed without the support of this discretionary grant assistance. This need is frequently referred to as 'additionality' and discretionary incentives are designed to ensure that all projects have an element of 'additionality'.

In countries and regions where discretionary incentives schemes are in operation, the level of assistance will very much depend on the type of project. In all cases however it must be demonstrated that the project and company are viable, and that the assistance is required to enable the project to proceed. In such cases therefore, it is essential for the application for assistance to be submitted before the project commences. This applies in all cases where discretionary incentives are in operation, except Greece and France where work can commence before approval has been given.

Although the criteria determining the level of assistance varies, they are generally similar in most countries. The main factors in determining the level of grant would include the following:

- the number of jobs created

- the degree of export orientation or import substitution
- high technological content or process
- use of local suppliers, raw materials
- level of unemployment in the area where the investment is being considered
- the firms long term growth potential
- increase in productivity
- adherence to environmental legislation
- increase in income level in the local economy

If a project is particularly mobile and could easily move to a new location when the value of the incentives is exhausted, it is now common for grant awarding authorities to insist that local management and decision making should be an important part of the investment. This is intended also to avoid the low skill assembly type of operations, or 'screw-driver plants' as they are referred to. It is intended that local management would extend the activities of the operation so that it can take root within the community. Another method of curbing excessive mobility, is to insert a penalty clause in the grant award contract. Such a clause would state that the grant would be repaid if the investor did not remain for a specific period.

In comparing locations, investors need to differentiate carefully between the amount of assistance which it has been stated is available, and that which is actually possible to achieve. In many cases there may be a big difference between the two.

It is now proposed to review the range of F.D.I. attractions available in a number of countries and locations. The review will address three main headings. They are:

- a) Financial/fiscal incentives*
- b) Non-financial incentives*

*a) Financial/fiscal incentives*

Under this heading, any incentive which will increase the revenue flowing into an enterprise or reduce cost outlays will be considered. It is therefore proposed to address sub-headings such as grants, loans, rebates and subsidies, and the control of business costs. We will also consider here items such as corporate tax rates, corporate tax holidays. All items under the heading of Financial/Fiscal Incentives are normally very much within the control of the government of the country or the grant giving authority, and can be easily modified and adjusted to improve the competitiveness of a region.

*b) Non-financial incentives*

Under this heading will be addressed factors which are frequently key decision making factors, but which may be difficult or sometimes impossible to financially quantify. They can be divided into two categories. Indirect cost incentives reduce or totally offset the indirect cost an investor has to bear. Examples are state-funded workers training, housing facilities or infrastructure. Preferential

treatment incentives discriminate in favour of the foreign investor in terms of market access or protection from domestic and/or foreign competition. High tariff rates on some competitors products is a discriminating protection. Government procurement contracts would be another.

An investor will make his final decision based on an evaluation of all of the factors and items outlined under those two main headings. Each investor will apply his own subjective assessment to each one of the factors, and the final rating of each factor will be influenced by a number of variables. Many of these variables will be affected by unknown influences such as the personality of the investor, the characteristics and circumstances of the investing firm, and characteristics and features which are specific to the project itself.

It is now proposed to undertake a rating of a number of countries and regions from the perspective of the 'average investor'. In this case the 'average' means the kind of emphasis which most investors for most projects would put on the various factors. In each case it is viewed from the perspective of a foreign investor who would be contemplating a European, American, or Japanese location.

For the purpose of this exercise, it is assumed that the project in question is highly mobile, in a growing world market, total investment over US\$30 million, projected employment 1 000 people and output sold on world markets. It is in the Electronics sector.

It can be assumed that a project such as this would be looking for a skilled labour force with some experience in the sector, labour availability, a competitive cost structure and in many cases some financial assistance. Some of the ratings in the attached tables have been taken from the IMD World Competitiveness Report 1995 which ranked over 40 countries under a whole range of criteria.

*Section 1*

**COUNTRY COMPARISON**



### Financial incentives

COUNTRY COMPARISON	GR	FR	GB	IRE	N.IR	ITL	SP	JAP	US
<b>GRANTS TOWARDS :</b>									
• Fixed Assets	4	3	4	7	6	8	8	5	
• Capital									
• Corporation Tax Relief		3	0	8	2	6	6	3	
• Employment	4	3	2	5	4		4	4	
• Staff Training			4	6	5		4		6
• Marketing									
• Feasibility Study									
• Priority Sector Development									3
• Strategic Development Planning									
• Research & Development	5	5	5	5	5	5	5	4	3
• Environment Protection	2		3		2	6			
• Enterprise Decentralisation									
• Key Worker Housing					4				
• Staff Re-location									
<b>SUB TOTAL</b>	<b>15</b>	<b>14</b>	<b>17</b>	<b>31</b>	<b>28</b>	<b>25</b>	<b>27</b>	<b>16</b>	<b>12</b>
<b>LOANS &amp; INVESTMENT SCHEMES:</b>									
• Low Interest Rate	6	6	6	6	6	6	6	5	3
• Repayment Moratorium									
• Revolving Fund									
• Business Expansion Schemes - Tax Efficient				3					
• Towards Key Worker Housing									
<b>SUB TOTAL</b>	<b>6</b>	<b>6</b>	<b>6</b>	<b>9</b>	<b>6</b>	<b>6</b>	<b>6</b>	<b>5</b>	<b>3</b>
<b>REBATES, SUBSIDIES &amp; DUTIES:</b>									
• Interest Subsidy	3					4		5	
• Rent on Premises	3	3	4	6	5	4			
• VAT on Equipment									
• Customs & Excise									
• Transfer Tax on Loan, Buildings									
<b>SUB TOTAL</b>	<b>6</b>	<b>3</b>	<b>4</b>	<b>6</b>	<b>5</b>	<b>8</b>		<b>5</b>	
<b>BUSINESS COSTS:</b>									
• Telecommunications	5	6	7	6	7	4	3	2	5
• Energy	3	7	5	5	4	2	3	2	8
• Social Services		2	7		7		3	6	6
• Transport	6		6	2	4	4	4	4	4
• Social Charges Relief		3				5	5		
<b>SUB TOTAL</b>	<b>14</b>	<b>18</b>	<b>25</b>	<b>13</b>	<b>22</b>	<b>15</b>	<b>18</b>	<b>14</b>	<b>23</b>
<b>GRAND TOTAL</b>	<b>41</b>	<b>41</b>	<b>52</b>	<b>59</b>	<b>61</b>	<b>54</b>	<b>49</b>	<b>40</b>	<b>38</b>
<b>GR = GERMANY, FR = FRANCE, GB = GREAT BRITAIN, IRE = IRELAND, N. IR = NORTHERN IRELAND, IT = ITALY, SP = SPAIN, JAP = JAPAN.</b>									

### Non-financial incentives

COUNTRY COMPARISON	GR	FR	GB	IRE	N.IR	IT	SP	JAP	US
<b>THE BUSINESS ENVIRONMENT:</b>									
• Market Size, Access & Purchasing Power	6	6	6	2	1	4	6	7	9
• Privileged Access to Public Procurement Contracts	4	6	5	2	3	3	5	5	
• Supply and access to Natural Resources/Feedstock			3		1			2	
<b>SUB TOTAL</b>	10	12	14	4	5	7	11	14	9
<b>HUMAN RESOURCES:</b>									
• Level of Skill	6	5	3	6	3	4	5	8	6
• Labour Costs of Salaries/Wages/Social Welfare	2	4	5	7	5	6	8	3	4
• Education Levels/Facilities	5	4	2	5	3	2	4	8	3
• Training Facilities	4		6	3	5	2		5	3
• Legislation	2	3	8	6	8	1		4	
• Management Availability	3	4	5	6	4	4	5	5	4
<b>SUB TOTAL</b>	22	20	29	33	28	19	22	33	20
<b>GOVERNMENT/POLITICAL:</b>									
• Investment in Infrastructure - Transport/Telecommunications etc.	5	5	4	3	4	2	4	6	5
• Development Plans: National/Regional/Sectoral	4	3		4	5	2	4		3
• Legislative Consistency				5				6	5
<b>SUB TOTAL</b>	9	8	4	12	9	4	8	12	13
<b>LAND &amp; BUILDINGS:</b>									
• Ownership Legislation			5	6	5			3	4
• Advance Factories & Business Parks			6	3	4				
• Public Owned 'Land Bank'	3			4					
• Private Development of Commercial Property	7		7	2	6				6
• Export Free Zones		3	4						
• Incubator Units									
<b>SUB TOTAL</b>	10	3	22	15	15			3	10
<b>GRAND TOTAL</b>	<b>51</b>	<b>43</b>	<b>65</b>	<b>64</b>	<b>57</b>	<b>30</b>	<b>45</b>	<b>62</b>	<b>52</b>

## *Section 2*

### **INCENTIVES IN EACH COUNTRY**

#### **Great Britain**

The most generous grants available in the United Kingdom are available in the UK's so called assisted areas, and in Northern Ireland. The assisted areas are designated regions of the UK where economic growth has been relatively slow or adversely affected by industrial restructuring.

In Britain, the main components of the regional incentive package are Regional Selective Assistance which, since the demise of the Regional Development Grant in the late eighties, has been the mainstay of the British regional incentive system, and Regional Enterprise Grants, which focus on small firms in the designated problem regions.

The most important scheme for new investment projects is Regional Selective Assistance (RSA). RSA is a discretionary grant, available for both manufacturing and service industries, with each project being appraised by Government officials on particular merits. Assistance is related to either the fixed capital costs of a project or the number of jobs created, or saved, by the project, normally within three years of its start.

The main criterion the project must satisfy is additionality. The claimant needs to demonstrate that the award of assistance is necessary for the project to proceed, to enable the scope of the project to be more extensive or to enhance the project in some way. RSA can be very valuable, particularly since it is related to the total investment in fixed assets.

Two kinds of assisted area exist: intermediate and development. The same kinds of grants are available in each. The difference is that, in theory, locating in a development area provides access to a larger grant than in an intermediate area.

RSA is primarily aimed at manufacturing companies but can also be offered to the service sector. It is available not only to companies making investments in the UK for the first time, but also to companies expanding, modernising or rationalising.

RSA usually comes in the form of a project grant which can either be capital related or job related. If the former, the grant is intended to be used to help cover the costs of land purchase, site preparation, or the acquisition of plant and machinery. If the latter, it is intended to meet some of the costs of hiring and training. While RSA can take the maximum value of British regional support up to the aid ceilings established by the European Commission, the amount of RSA actually offered represents the minimum necessary for the aided project to go ahead. The grant is limited by the lowest of three maxima (internal net grant equivalent (NGE), cost per job and European Commission ceilings). The first two ceilings are confidential. They do, however, fall within the EC limits, which

are 30 per cent NGE or 5 500 ECU per job created (up to a 40 per cent NGE maximum) in the Development Areas and 20 per cent NGE or 3 500 ECU per job created (up to a 25 per cent NGE maximum) in the Intermediate Areas.

Regional Enterprise Grants are of two types: Regional Investment Grants which are aimed at investment projects in the Development Areas undertaken by firms with fewer than 25 employees; and Regional Innovation Grants which offer support for product and process development for firms of less than 50 employees located mainly in the Development and Intermediate Areas.

## **Northern Ireland**

The incentive package available in Northern Ireland is, as already noted, distinct from British regional incentives. Regional Aid consists of a discretionary package of Selective Assistance. Selective Financial Assistance is an umbrella term for a package of incentives provided under the Industrial Development legislation consisting of the following:

- a) Capital Grants;
- b) Employment Grants;
- c) Interest Relief Grants or soft loans;
- d) Marketing Grants;
- e) Research and development grants;
- f) Corporation Tax Relief grants;
- g) Government factories and/or rent grants;
- h) Key worker housing grants and loans;
- i) Strategic Development Planning grants;
- j) Equity Finance/venture capital.

The package is project-related and discretionary and covers all eligible investment up to the level of a (confidential) cost-per-job limit. In addition, European Commission ceilings must be met.

### ***Rates of Award***

<i>Capital grants</i>	Although eligibility is discretionary, the rates of award have a fixed maximum percentage of capital investment of 30 per cent which applies throughout Northern Ireland. A supplementary discretionary award of up to 20 per cent is available for particularly attractive internationally mobile projects.
<i>Employment grant</i>	A per-capita grant related to the number of additional jobs created or maintained by the project. There is no specified rate of award. Grants are paid in arrears as employment targets are achieved.
<i>Interest relief grants</i>	These grants are paid in respect of interest incurred on external loans. They can be made available for periods of up to seven years. For the first three years the grant is at a broadly commercial rate (making the loan to which it relates interest-free), while for the next four years it is at three percent per annum. Occasionally a loan is awarded instead of an IRG where an external loan cannot be raised. Such a loan may have

a concession equivalent to that obtained by an IRG-aided commercial loan.

## France

Investment incentives in France are designed essentially to promote the creation of new jobs, especially in areas of high unemployment. Both central and local authorities provide incentives. Central government incentives are administered by the regional development agency DATAR (Délégation à l'aménagement du territoire et l'action régionale) and local incentives are handled by 12 regional development agencies.

Three main types of regionally based grant assistance are available in France:

**Prime pour l'aménagement du territoire (PAT)** is a negotiable grant that is nationally financed out of DATAR's budget. It is available to both French and foreign companies that are planning an investment worth at least FF 20 million. The grant is only available for companies that invest in designated areas between 1 January 1995 and 31 December 1999. Decree No. 95-149 of 6 February 1995 sets out revised eligibility criteria, as follows:

1. Creation by a new or existing company, of an enterprise employing a minimum of 20 permanent employees over three years.
2. Significant expansion of an existing company (increasing to a minimum of 20 employees in three years) or, in the case of a new activity, creating more than 60 permanent jobs over three years.
3. Transfer of an existing company to a top-priority zone, with the creation of at least 20 jobs, including transferred employees, over three years.

The PAT averages FF 60 000 per job created, up to an amount equal to 17 per cent of the total investment, or 25 per cent in top priority zones (28 per cent in the Enterprise Zone around Valenciennes, Douai and Avesnes-sur-Helpe in the north and 33 per cent in Corsica and the European Development Area at Longwy).

New enterprises that receive the PAT will be exempt from tax on profits for the first five years (total exoneration in first two years, with one quarter exonerated for the following three years).

Companies may also benefit from full or partial exemption from the "taxe professionnelle" for a one to five year period. This is a business tax paid to local authorities.

In top priority areas that fulfil certain criteria relating to unemployment, age of population, etc. companies may also benefit from a one year exoneration of social charges for the first 50 employees.

**The regional employment grant (Prime régionale à l'emploi) or PRE** is regionally financed and provides funds for the smaller company (parent company revenues of less than FF 300 million). The PRE offers a grant per job ranging from FF 10 000 - FF 40 000. PRE is subject to a maximum equal to 17 per cent of the total investment. PRE may not be combined with the PAT and may not be followed by application for another PRE within three years.

**The regional subsidy for company “start ups” (Prime régionale à la création d’entreprises)** or **PRCE** is allocated by the Direction régionale de l’industries (DRIRE). PRCE may be worth up to FF 150 000 (FF 200 000 in designated priority zones) and can be combined with a PRE or a PAT.

Another scheme launched by DATAR, the Fonds national pour l’aménagement du territoire (FNADT), provides financial support to companies that transfer their activities from the Paris region to any other part of France. This takes the form of a relocation grant paid directly to employees that move with their firms and is worth up to FF 80 000 per head. In addition, the employer may be eligible to receive either a PAT or a decentralisation grant worth up to Fr20 000 per job relocated (whether or not it is filled by someone who has moved from Paris).

Overall, French policy on incentives is part of regional development policy. However, a few incentives are still available throughout the country for new investments, expansions, acquisition or financially troubled manufacturing companies and the setting up of headquarter operations. Investments resulting in the creation of 200 or more jobs are particularly welcome. Companies are exempt from social security charges for the first employee hired, as well as for new employees who are over 50 years of age or who were hired after being unemployed for more than one year.

Rules governing tax exemption for direct investors are subject to fairly frequent change. Under current policy, newly created commercial firms may be exempted from corporate tax on a declining basis: 100 per cent relief on profits for their first 2 years of operation; 75 per cent for the third year; 50 per cent for the fourth year and 25 per cent for the fifth year. In order to qualify for this exemption, at least 50 per cent of the applicant firm must be free of direct or indirect ownership by another company, *i.e.* the applicant must own more than 50 per cent of the company.

For plants less than five years old, all VAT paid on equipment purchases is reimbursed immediately. In addition, under certain conditions, the transfer tax on acquisitions of land, buildings and businesses can be reduced.

Foreign companies locating R & D facilities in France may be eligible for specific R &D grants, subject to certain eligibility criteria. Investments must be in engineering, management or software development and cannot be located in the Paris area. On average, grants to FF 35 000 per job created (FF 50 000 in most urban areas) are available.

## **Germany**

Regional policy support to promote investment in trade, industry and related infrastructure is available in designated areas throughout Germany, including the new Laender of the former east Germany following reunification in 1990.

The key regional incentive in Germany is the Investment Grant (Investitionszuschuss) paid out of the funds of the Gemeinschaftsaufgabe (GA) programme. This grant, in combination with other specified regional aids, must fall within a matrix of so called maximum preferential rates. This matrix contains rate maxima varying between 10 per cent-23 per cent of eligible fixed investment according to location and project type.

The GA assisted area map was redesignated in July 1993 and came into force at the start of January 1994. The new map encompasses 22 per cent of the west German population (including west

Berlin). This assisted area map is valid for three years from 1994-1996. Following reunification, all the new Laender of East Germany were designated a GA assisted area for a period of five years. This eligibility (including east Berlin) has been extended by one year to 31 December 1996.

### ***Investment grant***

The investment grant is a discretionary, project related incentive paid out of the funds of the GA programme and invariably takes the form of a capital grant. Maximum rates of award vary according to location and project type and relate to regional assistance received in respect of the applicant's investment project. The rates may be exceeded by up to 10 per cent (12 per cent in the Laender in east Germany) when regional assistance is cumulated with other, non-regionally restricted forms of public assistance. The maxima favour the new Laender (east Germany) over the rest of the GA areas, favour particular types of Growth Point within the more generally-designated assisted areas, favour start up projects over expansions and both these project types over basic rationalisations and reorganisations, as outlined below:

**Investment grants - GA programme**  
Maximum preferential rates (%)

	Start up	Expansion	Rationalisation / Reorganisation
<b>East Germany</b>	23	20	15
<b>West Germany</b>			
'B' Growth point	18	15	10
'C' Growth point	15	12	10
Non-Growth point	12	12	10

*Source:* Author.

Under eligibility rules, not all of the combinations shown above are common. In east Germany, individual Laender are increasingly introducing regional differentiation in the award of aid within the maxima specified above.

Further, East German regions with above-average unemployment are now eligible for higher GA maximum award levels. In these regions, specified by the new Laender, GA maximum awards can be exceeded to the extent that the total maximum limits 35 per cent, 32 per cent or 27 per cent of the subsidy value are not exhausted through non regional grants (*e.g.* the investment allowance).

In addition to the basic investment grant, there is a special investment grant available for a firm's investment associated with the creation of high-grade jobs which will improve the innovative capability of the firm. In the new Laender of East Germany, the special investment grant is worth up to DM 40 000 per high-grade job (subject to a maximum of 40 per cent of gross annual income of

individual). In the other GA areas in the former West Germany, the grant is worth as follows, for each high-grade job created:

'B' Growth points	DM 20 000
'C' Growth points	DM 15 000
Non-Growth points	DM 15 000

In the case of certain expansion project cases, these limits may be exceeded by up to DM 10 000 subject to the maximum preferential rates above.

### ***ERP Regional Soft Loan***

ERP assistance is given under one of three schemes: regional development; promotion of new businesses by first time entrepreneurs and environmental protection. These schemes are available in both east and west Germany although the regional scheme is known as the Reconstruction Programme in the new Laender.

The ERP regional soft loan is a project-related incentive which, although discretionary in theory, is automatic in practice insofar as all applicants who fulfil the 'known' conditions of award can expect to receive assistance at the maximum rates of award.

The rate of interest (fixed for the duration of the loan) has a tendency to move in line with market rates, though there has not, in recent years, been a consistent differential between the two. No interest free periods are available with ERP loans. The loan principal covers up to 50 per cent of eligible investment, depending on project size, with a maximum loan ceiling of DM 1 million. Investment projects of up to DM 100 000 qualify for up to 40 per cent. For investments between DM 100 000-DM 125 000 the maximum loan award is DM 50 000.

Loan duration varies according to the nature of the assets being financed -- 10 years for plant and 15 years for buildings and there is a standard principal repayment holiday of two years, with repayment then following six-monthly. Guarantees are necessary, the applicant's bank being required to stand as full guarantor for the loan, with the applicant firm in turn providing the bank with guarantees (typically material guarantees).

The maximum award level for the ERP regional loan in west Germany was raised to DM 1 million in February 1994.

For the Reconstruction Programme created in 1992 -- the following conditions apply:

- the maximum loan ceiling is DM 2 million;
- the loan duration is 15 years for plant and 20 years for buildings;
- the principal repayment holiday is five years.

### **Italy**

Italy is divided into 20 regions, all with particular social and economic characteristics. There are huge differences between north and south in terms of economic development and for years there was a

range of incentives to promote investment in Italy's less developed regions. However, in 1993 the old system was abolished and regional development policy is gradually being renewed. Some help is available to companies investing in the Mezzogiorno, Italy's underdeveloped south. The region has been divided into three groups. Group A includes provinces with development priority; Group B relatively underdeveloped provinces and Group C above average development conditions.

### ***Cash grants***

- 15 per cent - 56 per cent of the investment,
- 56 per cent on priority projects such as precision engineering, electronic products,
- telecommunications.

### ***Loans***

- 30 per cent - 40 per cent of the investment.

### ***Interest subsidies***

- On investments of less than L 36 billion, 36 per cent of loan interest is repaid by the investor and the remainder is paid by the state.
- On investments of more than L 36 billion, 60 per cent of loan interest is repaid by the investor and the remainder is paid by the state.

### ***Low interest loans***

- 15 years for new industrial plants.
- For Research and Development projects.

### ***Tax incentives***

- No company registration tax, mortgage tax, stamp duties for business starting a new production activity in an incentive area.
- Exemptions from Corporation Tax and Municipal taxes (52.2 per cent) for ten years starting in the year that company first earns a profit.
- Exemption from social security payments for ten years.
- 50 per cent reduction of the registration tax on mergers and capital transfer contributions.
- four per cent on new machinery and equipment which is offset against company's sales tax liability.

### ***Incentives area***

The areas with the maximum incentives are in Southern Italy, including Sicily and Sardinia, *i.e.* the Mezzogiorno region. Other incentive areas are located in the Friuli Venezia Giulia region.

The total maximum assistance is 75 per cent of investment. This applies to both grants and loans.

## **Ireland**

The major incentive schemes operating in Ireland are administered by two agencies, Forbairt and IDA Ireland. Forbairt deals with the development of indigenous industry, while IDA Ireland concentrates its activities on foreign investment.

A discretionary, project related package of financial assistance is available, including:

- a) Capital Grants
- b) Employment Grants
- c) R & D Grants
- d) Training Grants

The total package is determined as a percentage of eligible fixed asset investment. Rates for new start ups are negotiable up to 60 per cent in designated areas and up to 45 per cent in non-designated areas. It should be noted that projects are seldom awarded these maxima. Rates for expansions cannot exceed 15 per cent of fixed asset investment. In cases where a new start-up project has a training requirement, a training grant may also be awarded. Training grants are not included in the limits applied to grant aid in respect of fixed-asset related investment and may cover up to 100 per cent of the cost to the undertaking of providing the training.

A discretionary, project related package of financial assistance primarily through employment grants, but including capital grants, rent subsidies and training grants is also available to internationally-traded service projects.

The incentive package may involve any combination of grants negotiated on a case by case basis, including employment grants, capital grants, rent subsidies and training grants (up to 100 per cent of eligible training costs). In practice, the base element of the package tends to be the employment grant. In respect of this grant, although no upper limit is specified in Irish legislation, the maximum award is normally up to IR£ 10 000 for every job created and certified.

The actual award depends on such factors as economic benefits and value-added to the economy, the quality of employment and skills involved, etc.

Eligible service industries are specified by the Minister for Industry & Employment by order under Section 3 of the 1986 Industrial Development Act. Broadly, eligibility is limited to internationally-tradable service activities, in particular to those activities which have potential for new job creation and are strategically important to future economic and industrial development, to 'start up' projects and major expansions and to projects which, amongst other things, have the potential to exploit international markets.

### *Types of grants & incentives*

The principal non-tax incentives for industry include:

- Capital grants
- Employment grants
- Rent subsidies
- Training grants
- Research and Development grants
- Feasibility study grants

### *Capital grants*

Cash grant towards the cost of providing new fixed assets in accordance with a planned investment programme are available to both overseas and existing industries. The level of grant aid is open to discussion with IDA, but the cost per job created and net value added retained in Ireland are key factors in its determination.

Projects located in certain designated areas which are mainly in the south, west and Northwest of the country qualify for a higher rate of grant, as these are the areas most in need of new sources of employment. The maximum legal rate of grant in the designated areas, may rise to 60 per cent of fixed asset investment costs in very exceptional circumstances. The maximum grant in non-designated areas is 45 per cent. Actual grant rates vary considerably and are influenced by industry sector, capital investment structure, employment content and location.

### *Employment grants*

As an alternative to capital related grants qualifying investors may receive employment grants. These grants are designed to assist the promoter to meet part of the payroll cost during the first year of operation on the project. An amount will be approved for each job created. One-half of the agreed amount per job will be paid on certification that the job has been created an one-half one year later, provided the job is still in existence.

### *Rent-reduction grants*

Where an investor intends to lease or rent a factory building, owned by IDA or a private property developer a grant towards the reduction of the annual rental payments may be available.

In addition, the IDA owns many serviced industrial sites and Industrial Buildings throughout Ireland which are available for sale to new industries. This standard factory space may be rented with an option to purchase (rental subsidised), purchased outright or purchased on a deferred basis (less capital grant).

### *Training grants*

Grants of up to 100 per cent are available towards the cost of training workers and management for new projects. The training costs which may be recouped include trainees' wages and travel and subsistence expenses either in Ireland or abroad. The cost of bringing training personnel to Ireland may also be recovered. The grants are also extended to the engagement of instructors, technical advisors or consultants to train or to assist in the training of persons for positions of supervision or management.

Training grants are based on specific training programmes agreed between each investing company, IDA and the Irish Industrial Training Authority (FÁS).

### *Research and Development (R&D) grants*

The IDA in conjunction with Forbairt operate a product and process development scheme to encourage Irish based, foreign and indigenous industrialists to undertake research and development of new and improved products in order to increase competitiveness and generate growth. The costs eligible for grant-aid include materials, wages and salaries, overhead charges, travel and subsistence expenses, technical consultancy fees and the provision of sites, premises, plant and equipment. Grant assistance of up to 50 per cent of eligible costs is available.

### *Feasibility study*

Companies based in Ireland investigating the feasibility of new products or markets may avail of a feasibility study grant. Grant aid is available at up to 50 per cent (subject to a maximum per project of £15 000) of expenditure, including salaries, travel costs, expenses and consultancy.

### *Ten per cent rate of tax*

Profits from a range of activities qualify for the ten per cent rate of tax up to 31 December 2010. These activities include:

- Manufacture of goods in Ireland, irrespective of where in the world the goods are sold.
- Provision of IDA employment grant aided software development, data processing and related technical and consultancy services
- Repair or re-manufacture of own manufactured computer equipment
- Income from international financial services in the IFSC in Dublin also qualify up to 31 December 2005.

## **Spain**

Spain's incentives programmes generally focus on underdeveloped areas, with incentives mainly administered by the 17 autonomous regional governments. However, the government does offer incentives to investors in certain specific sectors irrespective of geographical location, especially if the project involves research and development.

Some regional governments can offer more attractive incentives as a result of their greater fiscal autonomy. Indeed inter-regional competition to attract foreign capital can prove fruitful for some investors.

## ***Cash grants***

### *Training*

- Maximum 100 per cent of project cost -- for employment of young people and long term unemployed. Applies to all industries.

### *Employment grants*

- For persons aged 25 - 29 registered unemployed. Each employment contract qualifies for Ptas 500 000.
- For persons aged 45 years and over who have been long term unemployed.
- Each employment contract qualifies for Pta 500 000 plus 50 per cent discount on social security costs. Applies to all industries.

### *Agricultural*

For farming and food companies in general. Aims to improve the structures of production, transformation and commercialisation of their products. The maximum grant is 30 per cent of the cost of the investment.

### *Energy*

For hydroelectric power and for investments in alternative energy sources and energy conservation projects. The maximum grant available is 40 per cent of the cost of the investment.

### *Environment*

For projects aimed at environmental protection grants from 15 per cent - 60 per cent are available towards the cost of the project.

### *Mining*

To encourage geological and mining research, recovery of minerals and solid wastes safety, a maximum grant of 30 per cent of investment is available.

## ***Loans***

### *Research & Development*

To encourage modernisation and technological innovation, basic and applied research and industrial design:

- Maximum of 70 per cent of project costs
- Low interest loans
- Interest free loans. Maximum 40 per cent of investment.

### ***Tax incentives***

#### *Social Security*

- 50 per cent reduction of charges of newly hired employees for under 6 months contract.
- 90 per cent reduction on charges of newly hired employees for more than one year contract.
- 50 per cent - 100 per cent reduction on charges of employees of 45 years of age and over.

### ***Equity participation by government***

- Maximum 40 per cent of investment

### ***Incentives area***

For state investment incentives purposes, Spain is divided into Economic Promotion Zones and Special Zones. The geographical coverage of regional incentives is very broad and covers approximately 85 per cent of the national territory. Maximum cash grants and loans are available in Galicia (NW); Extremadura (SW) and Murcia (SE).

### ***Regional incentives***

#### *Autonomous regions*

These regions exercise their own local powers in such areas as law enforcement, education, medical services, social welfare programmes, city planning, public works, railroad, highways and ports.

They also provide their own incentives which are, in general, similar to those offered by the state.

The autonomous communities (17 in total) with the broadest powers are those of Cataluna, the Basque Country, Galicia and Andalucia.

### **The Basque Country incentives**

#### **Job creation grants**

- For investments up to Pta 500 million and 50 jobs -- a maximum grant of 1.2 million pesetas per job created.
- For investments from Pta 500 - Pta 4 000 million and 50 - 500 jobs -- a maximum grant of 40 per cent of investment.

#### **Environmental grants**

- Maximum 30 per cent of investment

#### **Research & Development**

- Maximum 58 per cent of investment

#### **Tax exemptions**

- For new companies:
- Maximum 100 per cent of corporation tax exemption for 10 years
- For existing companies:
- Maximum 45 per cent of corporation tax exemption for 10 years on new investments.

## **Japan**

The Japanese government offers incentives mainly to foster growth in specific industries. Government officials are especially eager to encourage investment in rural areas by high-tech firms, such as electronics and biotechnology concerns. There is no overt discrimination between foreign and Japanese firms in access to incentives, though some are designed primarily to spur foreign direct investment.

Many prefectural governments have their own subsidy system to encourage more industrial location. The contents of these systems vary from prefecture to prefecture, but one prefecture is paying a sum of up to Y 1.2 billion in subsidy.

At the national government level, the industry promotion subsidy and the regional employment promotion grant is given up to Y 28 000 per month for each new worker employed in a region where employment opportunities are insufficient.

Loans to finance relocation and construction of plants are granted by the Japan Development Bank. It also has a special loan programme for foreign companies making industrial investment in Japan. In addition to regional development loans offered by the Japan Development Bank and the Hokkaido-Tohoku Development Corporation, other government financial institutions offer loans. Many of the prefectural governments also have their own financial system for land acquisition, land development, plant and equipment funds, etc.

General incentives take the form of tax breaks and loan assistance.

### ***Tax incentives***

Japan offers a special corporate tax credit equal to 20 per cent of the tax-payer's annual increase in R & D expenditure, up to a maximum of ten per cent of total tax liability. Firms may also deduct seven per cent of the value of purchases of high-tech machinery for use in fundamental research. Up to 50 per cent of R & D expenses may be deducted for innovation in 'unexplored fields' including energy substitutes and environmental protection equipment.

### ***Capital incentives***

Capital incentives offered by the Japan Development Bank include long-term R & D loans and a grant programme for international joint research in advanced materials.

## USA

Foreign investment policy is one of 'neutrality with encouragement'. The generally open economic system fosters investment inflows without according foreigners special privileges.

State and local governments do not share the federal government's policy of investment neutrality. Economic development groups in the States spend hundreds of millions of dollars annually to attract foreign investment -- and to compete with one another in the process. About 40 states maintain one or more offices abroad to encourage investment in their areas. Most state and local incentives do not discriminate between foreign and domestic investors.

Tax breaks still form the main part of the incentives states have to offer the foreign investor and every state offers something in this area -- exemptions, reductions, holidays or a variation on one of these.

The most common approach is to provide tax incentives related to corporate income taxes, sales or use taxes, or property taxes. Other possibilities include property tax incentives.

States may also provide a whole range of incentives to promote activity in distressed areas, draw high-tech firms into their jurisdictions and provide infrastructure financing. State and local authorities also may provide public services in connection with a large investment, such as rail and highway connections and water and sewage facilities.

The state which enjoyed a boom year for foreign investment in 1995 was Oregon, a diminutive west coast US state. Such was its impact on the investment world that Oregon's economic development team was voted the world' top investment agency in 1995 by Corporate Location.

Foreign investment into Oregon, which has a population of just three million, escalated from \$100 million in 1993/1994 to \$3.6 billion the following year. The largest two investments -- from Fujitsu (\$1 billion) and Hyundai (\$1.3 billion) had both been prised out of Asia. Eight out of nine major investments into Oregon were from Asia. Oregon clinched deals by roping in support from local commerce and the public sector, a network which enabled the development agency to make investors a complete offer, with site, tax breaks, supply and services all thrown in.

## Texas

The Texas Department of Commerce offers a variety of incentive programs designed to make capital more available for businesses looking to expand or locate in the state, as well as for companies already doing business in Texas.

**Smart Jobs Fund** is a business incentive program designed to increase the competitiveness of Texas in the global economy. The program is administered by the Texas Department of Commerce. The Smart Jobs Fund provides direct grants to employers for customised training in emerging occupations in manufacturing industry. The program is 'employer driven' meaning that the employer determines what training is required for employment. All employers that have been in business for at least one year are eligible, so long as they meet the requirements set forth by the Texas legislature.

These requirements include certain salary levels and a worker retention period of three months after the training project is completed.

**Texas Enterprise Zone Program** is designed to encourage permanent job creation and retention, as well as capital investment in economically distressed areas of Texas. Businesses located in Enterprise Zones may be eligible for local and/or state benefits. State incentives include a refund of state sales and use taxes, franchise tax reductions, and state administered program priority. Additional state benefits are available to qualified businesses designated as enterprise projects, which are nominated by communities on a competitive basis. Local incentives may include real and/or personal property tax abatement, regulatory relief, job training services, housing improvements, refunds of local sales and use taxes, utility reductions, low-interest loans, and other incentives developed by participating communities.

**Texas Capital Fund** consists of three programs designed to promote growth in rural non-entitlement areas generally defined as cities with fewer than 50 000 residents or counties with less than 200 000 residents. Awards are made through eligible cities and counties to assist businesses that employ low to moderate income persons.

**Infrastructure Grant Program** - Funds may be used for construction and/or improvements of water or waste water facilities, public road construction, natural gas line services, rail spurs and electric power services. Minimum and maximum awards are \$50 000 and \$500 000 respectively. Awards may not exceed 50 per cent of the total project cost.

**Real Estate Development Program** - Funds may be used to acquire, construct or rehabilitate real estate to support a for-profit or a non-profit entry willing to commit to creating or retaining jobs primarily for low or moderate income persons. Minimum and maximum awards are \$50 000 and \$500 000 respectively. Awards may not exceed 50 per cent of the total project cost.

**Main Street Program** - Provides financial assistance to non-entitlement Main Street Cities (designated by the Texas Historical Commission) for public improvements.

**Texas Leverage Fund** - Economic Development Bank that offers financing to communities that have passed the economic development sales tax. May be used to provide financing to local businesses for industry expansion or recruitment, industrial parks establishment, or certain community project financing.

**Capital Certified Development Corporation** - Designed to make the Small Business Administration's 504 Loan Program available state-wide. The Capital Certified Development Corporation offers long-term loan financing at an attractive, fixed interest rate. It is geared towards businesses that have been in existence for at least three years and need financing for fixed assets such as land, buildings, machinery and equipment.

**Industrial Revenue Bonds** - The Texas Department of Commerce reviews applications for approval of Industrial Revenue Bonds with particular emphasis on the loan/lease agreement between the issuer and the user. IRB's are issued through economic development corporations and authorities and have a maximum amount of \$10 million.



*Section 3*

**CASE HISTORIES**

**Case studies**

In 1993/1994 IDA Ireland considered 20 projects in competition with other European locations. Ireland was not the selected location. The reasons for locating elsewhere were varied and complex and difficult to generalise. However, they can be broken down as follows:

<b>Reasons for locating elsewhere</b>	<b>Number</b>
Higher incentive offer	6
Market access	4
Acquisition	2
Lower costs	2
Other	6
<b>Total</b>	<b>20</b>

It is now proposed to look at some specific examples of projects that considered an investment location in Europe. We will give details of the project and where possible the reasons for locating where they did.

**Ford**

Project parameters:

Jobs: 1 700

Product: Car radios

Investment: £76.5 million

Company located: Portugal

Portuguese Grant offer: Capital & Training Grants of £38.5 million which equalled 50 per cent of Ford's total costs and 67 per cent of total fixed asset costs. = £22 676 per job

Ford selected a location in an old shipbuilding area south of Lisbon.

## **Ryobi**

Project parameters:		
Product:	Automotive component die-casting project	
Jobs:	100	
Locations considered:	Northern Ireland/Wales/Ireland	
Company located:	Northern Ireland	
Northern Ireland offer:	25 per cent Grant on Buildings costs of £4 million	£1.0 million
	25 per cent Grant on Machinery costs of £10 million	£2.5 million
	Training Grant of £250 000	£0.25 million
	Labour Grant of £6 000 x 100	<u>£0.6 million</u>
	Total	£4.35 million
Grant cost per job	£43 500	

## **Reasons for locating in Northern Ireland**

Ryobi was encouraged by one of their major customers, Ford to consider setting up a manufacturing plant close to their facility in Northern Ireland or Wales.

## **CIS Technology**

Project parameters:	
Products:	Floppy disks
Jobs:	212
Investment:	£11.1 million (excluding buildings)
Locations considered:	Ireland, Northern Ireland & England
Company located:	Northern Ireland
Northern Ireland offer:	Turnkey building organised by IDB (to CIS specs) ready 6 months after approval
	50 per cent Capital Grant on cost of building, the remaining 50 per cent to be paid off over ten years
	50 per cent Capital Grant on cost of machinery
	Training Grants
	Cheap bridging finance for machinery
	100 per cent of investment allowable (including portion grant aided) for depreciation purposes
	three year contingent grant liability
Estimated grant cost per job	£31 475

## **Siemens**

Project parameters:	
Product:	Microchip fabrication plant
Jobs:	1 800
Investment:	\$1.8 billion
Locations considered:	Ireland, England, Austria
Company located:	North East England
Grant offer:	£50 million (\$78.9 million)

### **Reasons for locating in N.E. England**

1. Siemens felt that the total time required to construct a building and bring the project on-stream was less in the UK. The UK is seen by Siemens as having an established track record in bringing large contracts on-stream quickly and efficiently.
2. Some of Siemens management were influenced by the need for more value added activities in the UK, to act as a hedge against currency swings.

### **Chunghwa**

Project parameters:

Product: Colour cathode ray tubes for PC's and televisions  
Jobs: 3 300 jobs over a 5 year period  
Locations considered: Ireland, Scotland  
Company located: Scotland  
Scottish offer: £80 - £100 million Sterling

### **Reasons for locating in Scotland**

1. The decision by Chunghwa to locate in Scotland was specifically related to the availability of a critical raw material (specialised glass) in the UK.
2. The presence of the one of the company's largest customers in Scotland.

### **Advanced Micro Devices**

Project parameters:

Product: Integrated circuits  
Jobs: 1 400  
Investment: £833 million  
Company located: Saxony, Germany  
Germany offered: £250 million = £178 571 grant per job

### **Reasons for locating in Germany**

1. Company wanted central location in Europe.
2. Grant package offered.

### **Siemens**

Project parameters:

Product: Micro chips  
Jobs: 1 450  
Investment: £1 125 million  
Company located: Saxony, Germany  
Germany offered: Grants of £333 million = Grant Cost per job of £229 655  
Additional R & D grants of £125 million were promised  
The company will also be eligible for extensive depreciation.

### **Reasons for locating in Germany**

1. Grant package offered.



*Appendix 1*

**INDIVIDUAL COUNTRY RATINGS**

**FINANCIAL INCENTIVES**  
**COUNTRY : Great Britain**

	RATING 0-10	EXPLANATORY NOTE
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**GRANTS TOWARDS**

• Fixed Assets	4	
• Capital		
• Corporation Tax Relief	0	
• Employment	2	
• Staff Training	4	
• Marketing		
• Feasibility Study		
• Priority Sector Development		
• Strategic Development Planning		
• Research & Development	5	
• Environment Protection	3	
• Enterprise Decentralisation		
• Key Worker Housing		
• Staff Re-location		
<b>SUB-TOTAL</b>	<b>17</b>	

**LOANS & INVESTMENT SCHEMES**

• Low Interest Rate	6	
• Repayment Moratorium		
• Revolving Fund		
• Business Expansion Schemes - Tax Efficient		
• Towards Key Worker Housing		
<b>SUB TOTAL</b>	<b>6</b>	

**REBATES, SUBSIDIES & DUTIES**

• Interest Subsidy		
• Rent on Premises	4	
• VAT on Equipment		
• Customs & Excise		
• Transfer Tax on Loan, Buildings		
<b>SUB TOTAL</b>	<b>4</b>	

**BUSINESS COSTS**

• Telecommunications	7	
• Energy	5	
• Social Services	7	
• Transport	6	
• Social Charges Relief		
<b>SUB TOTAL</b>	<b>25</b>	
<b>GRAND TOTAL</b>	<b>52</b>	

## NON-FINANCIAL INCENTIVES

### COUNTRY : Great Britain

	RATING 0-10	EXPLANATORY NOTE
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#### THE BUSINESS ENVIRONMENT

• Market Size, Access & Purchasing Power	6	
• Privileged Access to Public Procurement Contracts	5	
• Supply and access to Natural Resources/Feedstock	3	
<b>SUB TOTAL</b>	<b>14</b>	

#### HUMAN RESOURCES

• Level of Skill	3	
• Labour Costs of Salaries/Wages/Social Welfare	5	
• Education Levels/Facilities	2	
• Training Facilities	6	
• Legislation	8	
• Management Availability	5	
<b>SUB TOTAL</b>	<b>29</b>	

#### GOVERNMENT/POLITICAL

• Investment in Infrastructure - Transport/Telecommunications etc.	4	
• Development Plans: National/Regional/Sectoral		
• Legislative Consistency		
<b>SUB TOTAL</b>	<b>4</b>	

#### LAND & BUILDINGS

• Ownership Legislation	5	
• Advance Factories & Business Parks	6	
• Public Owned 'Land Bank'		
• Private Development of Commercial Property	7	
• Export Free Zones		
• Incubator Units		
<b>SUB TOTAL</b>	<b>22</b>	
<b>GRAND TOTAL</b>	<b>65</b>	

**FINANCIAL INCENTIVES**  
**COUNTRY : Northern Ireland**

	RATING 0-10	EXPLANATORY NOTE
<b>GRANTS TOWARDS</b>		
• Fixed Assets	6	
• Capital		
• Corporation Tax Relief	2	
• Employment	4	
• Staff Training	5	
• Marketing		
• Feasibility Study		
• Priority Sector Development		
• Strategic Development Planning		
• Research & Development	5	
• Environment Protection	2	
• Enterprise Decentralisation		
• Key Worker Housing		
• Staff Re-location	4	
<b>SUB-TOTAL</b>	<b>28</b>	
<b>LOANS &amp; INVESTMENT SCHEMES</b>		
• Low Interest Rate	6	
• Repayment Moratorium		
• Revolving Fund		
• Business Expansion Schemes - Tax Efficient		
• Towards Key Worker Housing		
<b>SUB TOTAL</b>	<b>6</b>	
<b>REBATES, SUBSIDIES &amp; DUTIES</b>		
• Interest Subsidy		
• Rent on Premises	5	
• VAT on Equipment		
• Customs & Excise		
• Transfer Tax on Loan, Buildings		
<b>SUB TOTAL</b>	<b>5</b>	
<b>BUSINESS COSTS</b>		
• Telecommunications	7	
• Energy	4	
• Social Services	7	
• Transport	4	
• Social Charges Relief		
<b>SUB TOTAL</b>	<b>22</b>	
<b>GRAND TOTAL</b>	<b>59</b>	

## NON-FINANCIAL INCENTIVES

### COUNTRY : Northern Ireland

	RATING 0-10	EXPLANATORY NOTE
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#### THE BUSINESS ENVIRONMENT

• Market Size, Access & Purchasing Power	1	
• Privileged Access to Public Procurement Contracts	3	
• Supply and access to Natural Resources/Feedstock	1	
<b>SUB TOTAL</b>	<b>5</b>	

#### HUMAN RESOURCES

• Level of Skill	3	
• Labour Costs of Salaries/Wages/Social Welfare	5	
• Education Levels/Facilities	3	
• Training Facilities	5	
• Legislation	8	
• Management Availability	4	
<b>SUB TOTAL</b>	<b>28</b>	

#### GOVERNMENT/POLITICAL

• Investment in Infrastructure - Transport/Telecommunications etc.	4	
• Development Plans: National/Regional/Sectoral	5	
• Legislative Consistency		
<b>SUB TOTAL</b>	<b>9</b>	

#### LAND & BUILDINGS

• Ownership Legislation	5	
• Advance Factories & Business Parks	4	
• Public Owned 'Land Bank'		
• Private Development of Commercial Property	6	
• Export Free Zones		
• Incubator Units		
<b>SUB TOTAL</b>	<b>15</b>	
<b>GRAND TOTAL</b>	<b>57</b>	

## FINANCIAL INCENTIVES

### COUNTRY : France

	RATING 0-10	EXPLANATORY NOTE
<b>GRANTS TOWARDS</b>		
• Fixed Assets	3	
• Capital		
• Corporation Tax Relief	3	
• Employment	3	
• Staff Training		
• Marketing		
• Feasibility Study		
• Priority Sector Development		
• Strategic Development Planning	5	
• Research & Development		
• Environment Protection		
• Enterprise Decentralisation		
• Key Worker Housing		
• Staff Re-location		
<b>SUB-TOTAL</b>	<b>14</b>	
<b>LOANS &amp; INVESTMENT SCHEMES</b>		
• Low Interest Rate	6	
• Repayment Moratorium		
• Revolving Fund		
• Business Expansion Schemes - Tax Efficient		
• Towards Key Worker Housing		
<b>SUB TOTAL</b>	<b>6</b>	
<b>REBATES, SUBSIDIES &amp; DUTIES</b>		
• Interest Subsidy		
• Rent on Premises	3	
• VAT on Equipment		
• Customs & Excise		
• Transfer Tax on Loan, Buildings		
<b>SUB TOTAL</b>	<b>3</b>	
<b>BUSINESS COSTS</b>		
• Telecommunications	6	
• Energy	7	
• Social Services	2	
• Transport		
• Social Charges Relief	3	
<b>SUB TOTAL</b>	<b>18</b>	
<b>GRAND TOTAL</b>	<b>41</b>	

## NON-FINANCIAL INCENTIVES

### COUNTRY : France

	RATING 0-10	EXPLANATORY NOTE
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#### THE BUSINESS ENVIRONMENT

• Market Size, Access & Purchasing Power	6	
• Privileged Access to Public Procurement Contracts	6	
• Supply and access to Natural Resources/Feedstock		
<b>SUB TOTAL</b>	<b>12</b>	

#### HUMAN RESOURCES

• Level of Skill	5	
• Labour Costs of Salaries/Wages/Social Welfare	4	
• Education Levels/Facilities	4	
• Training Facilities		
• Legislation	3	
• Management Availability	4	
<b>SUB TOTAL</b>	<b>20</b>	

#### GOVERNMENT/POLITICAL

• Investment in Infrastructure - Transport/Telecommunications etc.	5	
• Development Plans: National/Regional/Sectoral	3	
• Legislative Consistency		
<b>SUB TOTAL</b>	<b>8</b>	

#### LAND & BUILDINGS

• Ownership Legislation		
• Advance Factories & Business Parks		
• Public Owned 'Land Bank'		
• Private Development of Commercial Property		
• Export Free Zones		
• Incubator Units	3	
<b>SUB TOTAL</b>	<b>3</b>	
<b>GRAND TOTAL</b>	<b>43</b>	

## FINANCIAL INCENTIVES

### COUNTRY : Germany

	RATING 0-10	EXPLANATORY NOTE
<b>GRANTS TOWARDS</b>		
• Fixed Assets	4	
• Capital		
• Corporation Tax Relief		
• Employment	4	
• Staff Training		
• Marketing		
• Feasibility Study		
• Priority Sector Development		
• Strategic Development Planning	5	
• Research & Development	2	
• Environment Protection		
• Enterprise Decentralisation		
• Key Worker Housing		
• Staff Re-location		
<b>SUB-TOTAL</b>	<b>15</b>	
<b>LOANS &amp; INVESTMENT SCHEMES</b>		
• Low Interest Rate	6	
• Repayment Moratorium		
• Revolving Fund		
• Business Expansion Schemes - Tax Efficient		
• Towards Key Worker Housing		
<b>SUB TOTAL</b>	<b>6</b>	
<b>REBATES, SUBSIDIES &amp; DUTIES</b>		
• Interest Subsidy	3	
• Rent on Premises	3	
• VAT on Equipment		
• Customs & Excise		
• Transfer Tax on Loan, Buildings		
<b>SUB TOTAL</b>	<b>6</b>	
<b>BUSINESS COSTS</b>		
• Telecommunications	5	
• Energy	3	
• Social Services		
• Transport	6	
• Social Charges Relief		
<b>SUB TOTAL</b>	<b>14</b>	
<b>GRAND TOTAL</b>	<b>41</b>	

## NON-FINANCIAL INCENTIVES

### COUNTRY : Germany

	RATING 0-10	EXPLANATORY NOTE
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#### THE BUSINESS ENVIRONMENT

• Market Size, Access & Purchasing Power	6	
• Privileged Access to Public Procurement Contracts	4	
• Supply and access to Natural Resources/Feedstock		
<b>SUB TOTAL</b>	<b>10</b>	

#### HUMAN RESOURCES

• Level of Skill	6	
• Labour Costs of Salaries/Wages/Social Welfare	2	
• Education Levels/Facilities	5	
• Training Facilities	4	
• Legislation	2	
• Management Availability	3	
<b>SUB TOTAL</b>	<b>22</b>	

#### GOVERNMENT/POLITICAL

• Investment in Infrastructure - Transport/Telecommunications etc.	5	
• Development Plans: National/Regional/Sectoral	4	
• Legislative Consistency		
<b>SUB TOTAL</b>	<b>9</b>	

#### LAND & BUILDINGS

• Ownership Legislation		
• Advance Factories & Business Parks		
• Public Owned 'Land Bank'	3	
• Private Development of Commercial Property	7	
• Export Free Zones		
• Incubator Units		
<b>SUB TOTAL</b>	<b>10</b>	
<b>GRAND TOTAL</b>	<b>51</b>	

## FINANCIAL INCENTIVES

### COUNTRY : Italy

	RATING 0-10	EXPLANATORY NOTE
<b>GRANTS TOWARDS</b>		
• Fixed Assets	8	
• Capital		
• Corporation Tax Relief	6	
• Employment		
• Staff Training		
• Marketing		
• Feasibility Study		
• Priority Sector Development		
• Strategic Development Planning		
• Research & Development	5	
• Environment Protection	6	
• Enterprise Decentralisation		
• Key Worker Housing		
• Staff Re-location		
<b>SUB-TOTAL</b>	<b>25</b>	
<b>LOANS &amp; INVESTMENT SCHEMES</b>		
• Low Interest Rate	6	
• Repayment Moratorium		
• Revolving Fund		
• Business Expansion Schemes - Tax Efficient		
• Towards Key Worker Housing		
<b>SUB TOTAL</b>	<b>6</b>	
<b>REBATES, SUBSIDIES &amp; DUTIES</b>		
• Interest Subsidy	4	
• Rent on Premises	4	
• VAT on Equipment		
• Customs & Excise		
• Transfer Tax on Loan, Buildings		
<b>SUB TOTAL</b>	<b>8</b>	
<b>BUSINESS COSTS</b>		
• Telecommunications	4	
• Energy	2	
• Social Services		
• Transport	4	
• Social Charges Relief	5	
<b>SUB TOTAL</b>	<b>15</b>	
<b>GRAND TOTAL</b>	<b>54</b>	

## NON-FINANCIAL INCENTIVES

### COUNTRY : Italy

	RATING 0-10	EXPLANATORY NOTE
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#### THE BUSINESS ENVIRONMENT

• Market Size, Access & Purchasing Power	4	
• Privileged Access to Public Procurement Contracts	3	
• Supply and access to Natural Resources/Feedstock		
<b>SUB TOTAL</b>	<b>7</b>	

#### HUMAN RESOURCES

• Level of Skill	4	
• Labour Costs of Salaries/Wages/Social Welfare	6	
• Education Levels/Facilities	2	
• Training Facilities	2	
• Legislation	1	
• Management Availability	4	
<b>SUB TOTAL</b>	<b>19</b>	

#### GOVERNMENT/POLITICAL

• Investment in Infrastructure - Transport/Telecommunications etc.	2	
• Development Plans: National/Regional/Sectoral	2	
• Legislative Consistency		
<b>SUB TOTAL</b>	<b>4</b>	

#### LAND & BUILDINGS

• Ownership Legislation		
• Advance Factories & Business Parks		
• Public Owned 'Land Bank'		
• Private Development of Commercial Property		
• Export Free Zones		
• Incubator Units		
<b>SUB TOTAL</b>		
<b>GRAND TOTAL</b>	<b>30</b>	

## FINANCIAL INCENTIVES

### COUNTRY : Ireland

	RATING 0-10	EXPLANATORY NOTE
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#### GRANTS TOWARDS

• Fixed Assets	7	
• Capital		
• Corporation Tax Relief	8	
• Employment	5	
• Staff Training	6	
• Marketing		
• Feasibility Study		
• Priority Sector Development		
• Strategic Development Planning	5	
• Research & Development		
• Environment Protection		
• Enterprise Decentralisation		
• Key Worker Housing		
• Staff Re-location		
<b>SUB-TOTAL</b>	<b>31</b>	

#### LOANS & INVESTMENT SCHEMES

• Low Interest Rate	6	
• Repayment Moratorium		
• Revolving Fund		
• Business Expansion Schemes - Tax Efficient	3	
• Towards Key Worker Housing		
<b>SUB TOTAL</b>	<b>9</b>	

#### REBATES, SUBSIDIES & DUTIES

• Interest Subsidy		
• Rent on Premises	6	
• VAT on Equipment		
• Customs & Excise		
• Transfer Tax on Loan, Buildings		
<b>SUB TOTAL</b>	<b>6</b>	

#### BUSINESS COSTS

• Telecommunications	6	
• Energy	5	
• Social Services		
• Transport	2	
• Social Charges Relief		
<b>SUB TOTAL</b>	<b>13</b>	
<b>GRAND TOTAL</b>	<b>59</b>	

## NON-FINANCIAL INCENTIVES

### COUNTRY : Ireland

	RATING 0-10	EXPLANATORY NOTE
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#### THE BUSINESS ENVIRONMENT

• Market Size, Access & Purchasing Power	2	
• Privileged Access to Public Procurement Contracts	2	
• Supply and access to Natural Resources/Feedstock		
<b>SUB TOTAL</b>	<b>4</b>	

#### HUMAN RESOURCES

• Level of Skill	6	
• Labour Costs of Salaries/Wages/Social Welfare	7	
• Education Levels/Facilities	5	
• Training Facilities	3	
• Legislation	6	
• Management Availability	6	
<b>SUB TOTAL</b>	<b>33</b>	

#### GOVERNMENT/POLITICAL

• Investment in Infrastructure - Transport/Telecommunications etc.	3	
• Development Plans: National/Regional/Sectoral	4	
• Legislative Consistency	5	
<b>SUB TOTAL</b>	<b>12</b>	

#### LAND & BUILDINGS

• Ownership Legislation	6	
• Advance Factories & Business Parks	3	
• Public Owned 'Land Bank'	4	
• Private Development of Commercial Property	2	
• Export Free Zones		
• Incubator Units		
<b>SUB TOTAL</b>	<b>15</b>	
<b>GRAND TOTAL</b>	<b>63</b>	

## FINANCIAL INCENTIVES

### COUNTRY : Spain

	RATING 0-10	EXPLANATORY NOTE
<b>GRANTS TOWARDS</b>		
• Fixed Assets	8	
• Capital		
• Corporation Tax Relief	6	
• Employment	4	
• Staff Training	4	
• Marketing		
• Feasibility Study		
• Priority Sector Development		
• Strategic Development Planning		
• Research & Development	5	
• Environment Protection		
• Enterprise Decentralisation		
• Key Worker Housing		
• Staff Re-location		
<b>SUB-TOTAL</b>	<b>27</b>	
<b>LOANS &amp; INVESTMENT SCHEMES</b>		
• Low Interest Rate	3	
• Repayment Moratorium		
• Revolving Fund		
• Business Expansion Schemes - Tax Efficient		
• Towards Key Worker Housing		
<b>SUB TOTAL</b>	<b>3</b>	
<b>REBATES, SUBSIDIES &amp; DUTIES</b>		
• Interest Subsidy		
• Rent on Premises		
• VAT on Equipment		
• Customs & Excise		
• Transfer Tax on Loan, Buildings		
<b>SUB TOTAL</b>		
<b>BUSINESS COSTS</b>		
• Telecommunications	3	
• Energy	3	
• Social Services	3	
• Transport	4	
• Social Charges Relief	5	
<b>SUB TOTAL</b>	<b>18</b>	
<b>GRAND TOTAL</b>	<b>49</b>	

## NON-FINANCIAL INCENTIVES

### COUNTRY : Spain

	RATING 0-10	EXPLANATORY NOTE
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#### THE BUSINESS ENVIRONMENT

• Market Size, Access & Purchasing Power	6	
• Privileged Access to Public Procurement Contracts	5	
• Supply and access to Natural Resources/Feedstock		
<b>SUB TOTAL</b>	<b>11</b>	

#### HUMAN RESOURCES

• Level of Skill	5	
• Labour Costs of Salaries/Wages/Social Welfare	8	
• Education Levels/Facilities	4	
• Training Facilities		
• Legislation		
• Management Availability	5	
<b>SUB TOTAL</b>	<b>22</b>	

#### GOVERNMENT/POLITICAL

• Investment in Infrastructure - Transport/Telecommunications etc.	4	
• Development Plans: National/Regional/Sectoral	4	
• Legislative Consistency		
<b>SUB TOTAL</b>	<b>8</b>	

#### LAND & BUILDINGS

• Ownership Legislation		
• Advance Factories & Business Parks		
• Public Owned 'Land Bank'		
• Private Development of Commercial Property		
• Export Free Zones		
• Incubator Units		
<b>SUB TOTAL</b>		
<b>GRAND TOTAL</b>	<b>45</b>	

## FINANCIAL INCENTIVES

### COUNTRY : Japan

	RATING 0-10	EXPLANATORY NOTE
<b>GRANTS TOWARDS</b>		
• Fixed Assets	5	
• Capital		
• Corporation Tax Relief	3	
• Employment	4	
• Staff Training		
• Marketing		
• Feasibility Study		
• Priority Sector Development		
• Strategic Development Planning		
• Research & Development	4	
• Environment Protection		
• Enterprise Decentralisation		
• Key Worker Housing		
• Staff Re-location		
<b>SUB-TOTAL</b>	<b>16</b>	
<b>LOANS &amp; INVESTMENT SCHEMES</b>		
• Low Interest Rate	5	
• Repayment Moratorium		
• Revolving Fund		
• Business Expansion Schemes - Tax Efficient		
• Towards Key Worker Housing		
<b>SUB TOTAL</b>	<b>5</b>	
<b>REBATES, SUBSIDIES &amp; DUTIES</b>		
• Interest Subsidy	5	
• Rent on Premises		
• VAT on Equipment		
• Customs & Excise		
• Transfer Tax on Loan, Buildings		
<b>SUB TOTAL</b>	<b>5</b>	
<b>BUSINESS COSTS</b>		
• Telecommunications	2	
• Energy	2	
• Social Services	6	
• Transport	4	
• Social Charges Relief		
<b>SUB TOTAL</b>	<b>14</b>	
<b>GRAND TOTAL</b>	<b>40</b>	

## NON-FINANCIAL INCENTIVES

### COUNTRY : Japan

	RATING 0-10	EXPLANATORY NOTE
--	----------------	---------------------

#### THE BUSINESS ENVIRONMENT

• Market Size, Access & Purchasing Power	7	
• Privileged Access to Public Procurement Contracts	5	
• Supply and access to Natural Resources/Feedstock	2	
<b>SUB TOTAL</b>	<b>14</b>	

#### HUMAN RESOURCES

• Level of Skill	8	
• Labour Costs of Salaries/Wages/Social Welfare	3	
• Education Levels/Facilities	8	
• Training Facilities	5	
• Legislation	4	
• Management Availability	5	
<b>SUB TOTAL</b>	<b>33</b>	

#### GOVERNMENT/POLITICAL

• Investment in Infrastructure - Transport/Telecommunications etc.	6	
• Development Plans: National/Regional/Sectoral		
• Legislative Consistency	6	
<b>SUB TOTAL</b>	<b>12</b>	

#### LAND & BUILDINGS

• Ownership Legislation	3	
• Advance Factories & Business Parks		
• Public Owned 'Land Bank'		
• Private Development of Commercial Property		
• Export Free Zones		
• Incubator Units		
<b>SUB TOTAL</b>	<b>3</b>	
<b>GRAND TOTAL</b>	<b>62</b>	

## FINANCIAL INCENTIVES

### COUNTRY : USA

	RATING 0-10	EXPLANATORY NOTE
<b>GRANTS TOWARDS</b>		
• Fixed Assets		
• Capital		
• Corporation Tax Relief		
• Employment		
• Staff Training	6	
• Marketing		
• Feasibility Study		
• Priority Sector Development	3	
• Strategic Development Planning		
• Research & Development	3	
• Environment Protection		
• Enterprise Decentralisation		
• Key Worker Housing		
• Staff Re-location		
<b>SUB-TOTAL</b>	<b>12</b>	
<b>LOANS &amp; INVESTMENT SCHEMES</b>		
• Low Interest Rate	3	
• Repayment Moratorium		
• Revolving Fund		
• Business Expansion Schemes - Tax Efficient		
• Towards Key Worker Housing		
<b>SUB TOTAL</b>	<b>3</b>	
<b>REBATES, SUBSIDIES &amp; DUTIES</b>		
• Interest Subsidy		
• Rent on Premises		
• VAT on Equipment		
• Customs & Excise		
• Transfer Tax on Loan, Buildings		
<b>SUB TOTAL</b>		
<b>BUSINESS COSTS</b>		
• Telecommunications	5	
• Energy	8	
• Social Services	6	
• Transport	4	
• Social Charges Relief		
<b>SUB TOTAL</b>	<b>23</b>	
<b>GRAND TOTAL</b>	<b>38</b>	

## NON-FINANCIAL INCENTIVES

### COUNTRY : USA

	RATING 0-10	EXPLANATORY NOTE
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#### THE BUSINESS ENVIRONMENT

• Market Size, Access & Purchasing Power	9	
• Privileged Access to Public Procurement Contracts		
• Supply and access to Natural Resources/Feedstock		
<b>SUB TOTAL</b>	<b>9</b>	

#### HUMAN RESOURCES

• Level of Skill	6	
• Labour Costs of Salaries/Wages/Social Welfare	4	
• Education Levels/Facilities	3	
• Training Facilities	3	
• Legislation		
• Management Availability	4	
<b>SUB TOTAL</b>	<b>20</b>	

#### GOVERNMENT/POLITICAL

• Investment in Infrastructure - Transport/Telecommunications etc.	5	
• Development Plans: National/Regional/Sectoral	3	
• Legislative Consistency	5	
<b>SUB TOTAL</b>	<b>13</b>	

#### LAND & BUILDINGS

• Ownership Legislation	4	
• Advance Factories & Business Parks		
• Public Owned 'Land Bank'		
• Private Development of Commercial Property	6	
• Export Free Zones		
• Incubator Units		
<b>SUB TOTAL</b>	<b>10</b>	
<b>GRAND TOTAL</b>	<b>52</b>	



## Chapter 5

### FOREIGN DIRECT INVESTMENT INCENTIVES AND DISINCENTIVES IN TRANSITION ECONOMIES

by

Alena Zemplerova

Center For Economic Research And Graduate Education, Charles University, Prague

#### 1. Introduction

There are, in all countries, **general business climate conditions** (macroeconomic and political stability, natural resources) specific to investors and investment. The investment environment is regularly monitored by independent professional agencies and the results are published in a complex index, which includes factors influencing the country risk for investment. Depending on these ratings, investors are either encouraged or dissuaded from investing in the country.

Investors are further influenced in their decisions by **special incentives designed specifically for investors**. Incentives, controlled by state or local governments, can be provided either automatically or on a case-by-case basis and can be applied to the whole economy or to certain sectors only. Governments can consider *domestic investors* to be *a priori* inferior to foreign investors, thereby providing special investment incentives only to the latter, or they can maintain certain reservations towards *foreign investors* (usually for political reasons) by placing administrative barriers against foreign investment. Such disincentives can include restrictions on the ownership of land and/or ownership of real estate by a foreign investor, special approvals, restrictions on certain sectors, etc.

Government motivation for using foreign direct investment (FDI) incentives is stronger in transition economies than in Western countries. This is so for a variety of reasons, including a perceived lack of domestic capital and managerial knowledge in the former centrally planned economies. Structural changes, modernisation and extension of services and infrastructure sectors need capital and know-how, which are more easily available from foreign investors. FDI incentives are more generous in Western countries than in countries in transition largely because budgetary constraints are tougher in transition countries.

There is a consensus in Central and Eastern Europe that FDI is an important factor in the transformation and restructuring of the economy. There is no consensus, however, as to how to attract foreign investors, what instruments to employ in order to diminish the cost of the policies, the incentives to be applied, and the existence of extra-benefits induced by the latter.

During the first years of the transition process, all governments provided tax holidays and other incentives to foreign investors. Nevertheless, only modest amounts of FDI have been attracted to transition countries. Low efficiency of special incentives, together with experiences with existing FDI that were not always positive, led to a modification of FDI policies in these countries.

In some cases, foreign investors also expressed their disillusion with investment in transition economies, which can probably not be overcome by special FDI incentives.<sup>1</sup>

This study seeks to describe and evaluate current incentive policies for FDI in transition economies. In order to fulfil this task, a questionnaire was elaborated and a survey among selected transition economies was carried out (see *Appendix II* for the questionnaire and methodology).

The survey is not aimed at giving a complex or accurate description of FDI incentives, but at illustrating the general approach of governments towards FDI, the prevalent character of FDI incentives, and the integration of FDI incentives into the scheme of investment promotion in the country (as applied to both foreign and domestic investors).

The criterion for the selection of countries was based on the extent of foreign involvement in the economy; more specifically, the amount of FDI flows and stock and the stock of FDI per capita (see Table 2 in *Appendix I*). The purpose was to involve countries that were successful and less successful in attracting FDI.

An overview of FDI incentives in the following countries in transition are provided for: Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, Slovakia and Slovenia.

### *1. Type, character and efficiency of FDI incentives*

Macroeconomic developments, political stability, labour cost and skills or liberalisation of the economy are reflected by complex country risk rating, and investment or credit risk rating. There is no correlation, at least in the short term, between the flows and stocks of FDI and investment rating. (See *Appendix I*, Table 1 and Table 2 for an example of rating and FDI flows and stocks). It would appear that additional factors are motivating foreign investors' decisions. FDI is one such factor.

FDI incentives are administrative measures applied by governmental bodies at all levels and over which they have direct control. For the purpose of this study, the following working definitions of incentives have been adopted:

**Financial incentives** are tax holidays, corporate tax and VAT relief, accelerated depreciation, customs duties exemptions and deductions of the re-invested profit from the taxable base, loss carry forward over (fiscal). Non-fiscal financial incentives are subsidies for employment, R&D grants, loans (usually subsidised), subsidies to infrastructure, and other rebates and subsidies.

**Non-financial incentives** are measures which limit competition and thus decrease uncertainty and risk for the business operation through the provision of monopoly or preferential treatment (market access protection, exclusive licensing, exemption on access to foreign exchange and the like).

In the case of financial incentives, costs are subsidised directly and the subsidy (FDI cost) is quantifiable -- non-financial incentives allow for extra (monopoly) profit, which is difficult to quantify.

The way incentives are implemented is also important. Incentives provided to investors can be granted either **automatically** to all foreign investors or **selectively** to some investors if certain conditions are fulfilled.

Table 1. **FDI incentives in transition economies**

	Bulgaria	Czech Republic	Hungary	Poland	Romania	Russia	Slovakia	Slovenia
<b>Tax holiday or reduction provided</b>								
to all investors			x	x	x	x		x
to foreign investors								
selectively only								
<b>Important tax deductible or loss carry over</b>								
to all investors	x	x	x				x	x
to foreign investors					x			
selectively only				x				
<b>Cash rebates for job creation</b>								
to all investors			x			x		x
to foreign investors								
selectively only							x	
<b>Subsidy to capital available</b>								
to all investors								x
to foreign investors								
selectively only			x			x		
<b>Subsidy to infrastructure available</b>								
to all investors			x					x
to foreign investors					x			
selectively only	x			x				
<b>Custom relief or custom reduction possible</b>								
to all investors			x <sup>1</sup>					
to foreign investors	x	x <sup>2</sup>						
selectively only				x	x			
<b>Regional incentives provided</b>								
to all investors								
to foreign investors	x		x				x	
selectively only								
<b>Sectoral incentives provided</b>								
to all investors			x					
to foreign investors								
selectively only				x	x			
Market protection (selective)	x	x	x	x	x	x	x	x
Number of incentives	5	3	9	6	6	4	4	6
o/w FDI incentives	2	1	1	0	2	0	1	0
selective incentives	1	0	1	4	2	1	1	0

1. Special free trade zone exists

2. Valid only until the end of 1996

Source: Survey 1996.

Where FDI incentives are provided only to foreign investors, and thus domestic entrepreneurs are discriminated against, it leads to the creation of fake joint-ventures with the purpose of enjoying the advantages of FDI incentives. This was the case of tax holidays in existence prior to 1993 in almost all transition countries and which resulted primarily in the growth of small joint ventures which were not really in operation. (Compare Chirp-Zemplerova 1993 or Sass 1996).

Any selective approach requires that the foreign direct investment agency decides whether and which investors qualify for FDI incentives. The official argument for choosing a selective approach in providing incentives is that the government would like *a priori* to exclude the “bad” from the “good” FDI. The “good” investor is officially considered to be one who will restructure (possibly without creating further unemployment), make profits which are not transferred abroad, increase productivity, export the major share of output, etc.

The possibility of selection gives power to the bureaucracy, increases the costs of the incentives, and provides opportunity for corruption. The greater the number of conditions to be fulfilled by the investor, the less the transparency and the greater the possibility of manipulation. In addition, selective approaches also postpone decisions and, in reality, dissuade investors while serving primarily to demonstrate who decides what in the country: the market or the bureaucrat ?

Important deals can be negotiated on an individual, **case by case** basis between multinationals and the government representative. Incentives are “sold” for future investment promises or given free of charge.

## 2. *FDI incentives related to foreign trade*

Customs relief or reductions related to foreign investment which allow for the import of high technology, raw materials or intermediate products, is a widely used incentive to attract foreign investors. In some countries these allowances are provided only to the foreign investor, in others, domestic investors are also eligible. Again, these measures require control; it must be decided whether the technology is high-tech, whether the material is processed enough, etc. These operations are costly and allow for rent seeking.

The general liberalisation of trade enabled enterprises to establish domestic company to foreign company relations. This occurred earlier in the Hungarian case and within a few years it resulted in the creation of joint-ventures or in the acquisition of a Hungarian company by its former trade partner.

Another special regulation exists specifically in Hungary and has not yet been fully evaluated. There are special regulations for custom-free zones in Hungary, whereas in other Central European Free Trade Agreement (CEFTA) countries, such as the Czech Republic, Poland and Slovakia, custom-free zones do not have any significant impact on the inflows of foreign capital. The regulations in Hungary differ from other countries in that every foreign firm can set up its own customs-free zone in which it can obtain special tax allowances (see Hunya 1996 and Sass 1996). Some activities, however, are exempt.

International trade policy in transition economies which are members of the World Trade Organisation (WTO) are being liberalised: national tariffs are applied at relatively low rates and there are attempts to remove non-tariff barriers to trade.

The existence of anti-dumping and safeguard measures can also play an important role. Subsidies to state enterprises which decrease their costs, and thus artificially increase competitiveness in the short term, are also likely to be reduced and/or eliminated.

Countries in transition create certain “regions” according to their geographical location and the “maturity and progress in transition”. The Central European Free Trade Agreement (CEFTA) was established by the Czech Republic, Hungary, Poland, Slovakia and Slovenia. These countries were economically more developed before they became socialist and centrally planned, and the transition progressed at a significantly faster rate. They have overcome most of the institutional, organisational, and structural problems related to the transition from a centrally planned to a market economy.

Initiatives creating **free trade zones and free trade regions** have started to play an important role in attracting FDI. For example, in Hungary the legal framework for off-shore activities -- more liberal than in the majority of other countries -- attracted big export-oriented investors who received free-trade zone status which exempted them from Hungarian customs, currency, and book-keeping regulations. These foreign-owned companies were mostly greenfield investments and they did not have to overcome the usual bureaucratic hurdles, while having very little contact with the local economy (the spill-over effects of such off-shore companies are nil). The desire to protect certain markets or “sensitive products”, however, is becoming stronger and is often requested by foreign investors.

### 3. *Regional and sectoral FDI incentives*

An increasing number of local governments execute **FDI policies and incentives at regional levels**. As state governments cease to provide FDI incentives, initiatives at lower levels of government, where more in-depth knowledge on the regional situation exists, are being promoted.

The reason for this might also be the shift from acquisitions to greenfield investment. As the number of state enterprises decreases, and thus opportunities for acquisitions, greenfield investments have started to play a more important role. In this case, investors do not bear restructuring costs.

Table 2. **Investment incentives provided to foreign investors in certain regions** (1996)

	Local government incentives	Sectoral incentives
Bulgaria	no	no
Czech Republic	yes, exempt	no
Hungary	yes	yes
Poland	yes	yes
Romania	no	no
Russian Federation	yes	yes
Slovakia	yes	yes
Slovenia	no	no

*Source:* Survey 1996.

It is important that incentives granted to investors to promote the development of various regions and the control of these incentives by lower level governments be cumulated. The Governments of Hungary, the Czech Republic and Poland often compete for foreign investment as they strive to be the hub for export to other parts of Eastern Europe. The regional package of FDI incentives can often be decisive. Recently, the Japanese giant Matsushita decided to invest US\$66 million in a plant for the assembly of Panasonic TV sets located in Pilsen, Czech Republic. Although the Czech government

refused to provide the Japanese investor with special incentives, the local government in Pilsen not only sold the land (17 hectares) very cheaply, (US\$11.5 per square meter), but also agreed to build infrastructure equipment on this land for about US\$4 million. They will also provide assistance with hiring and training employees, local transport for employees, as well as accommodation for Japanese employees.

#### *4. Case-by-case approach to FDI incentives*

FDI flows are influenced by large deals negotiated on a case by case basis. In many cases, government officers or ministers have to act as managers. In the Czech Republic, the largest projects are: Skoda-Volkswagen, Tabak-Philip Morris, Cokoladovny-Nestle, Technoplyn-Linde, SPT Telecom/TelSource. The largest foreign investment was realised by the sale in the second half of 1995 of 27 per cent of SPT Telecom to the Dutch-Swiss consortium TelSource for US\$1.3 billion. Almost half of the total foreign direct investment comes from these large projects.

In December 1995, Hungary closed several large privatisation deals with foreign investors which had a significant impact on FDI. Minority stakes in four regional gas distributors, six regional electricity distributors and two electric power stations were sold for about US\$1.7 billion, with an option to acquire majority ownership in the future. Eighteen per cent of the Hungarian national oil company and 37 per cent of the Hungarian telecom company were sold. Two huge financial institutions have been privatised to foreign investors; about one third of the Hungarian Savings Bank and half of the shares of the Budapest Bank have been sold.

In the privatisation process, FDI can be promoted or suppressed: some sectors can be closed for privatisation and others are still closed to foreigners.

In Hungary, the privatisation of public utilities and financial institutions -- sectors usually closed to foreign investors -- have been planned and realised by the government.

Contrary to the situation in Hungary, the Czech government is still hesitating in selling public utilities and financial institutions to foreign investors, although deals are in preparation.

The Czech Republic also differs from Hungary in that it does not suffer either from macroeconomic instability or budget deficits. There are also differences in the labour market since the Czech Republic does not have a high rate of unemployment. Thus, privatisation revenues are not as important to the national budget as they are for Hungary.

Despite the privatisation strategy, about two thirds of the total stock of FDI in the country come from the privatisation of state property. The remaining FDI is greenfield or foreign investment in already-privatised enterprises.

With the existence of large investors, who usually possess a dominant position on the domestic market, the threat of limited competition being imposed by multinational companies exists. This is reflected by certain lobbying practices which seek to impose administrative barriers; as a result, the weakness of the government, or even Parliament, could be an important factor in attracting foreign investors. The following is an example of such lobbying practices: Philip Morris, which had invested in Tobacco Kutna Hora, lobbied the Czech Parliament to make it approve a law prohibiting the construction of new tobacco plants by imposing unrealistic time constraints. After an unsuccessful first attempt, Philip Morris came back with a suggestion to impose an increased rate of excise tax on short cigarettes, the main product of its major competitor, the Remtsma Company.

## 5. *Disincentives for foreign investors*

Governments in transition countries have, as a rule, a positive attitude towards foreign investment. Attracting foreign capital is considered to be a success and a sign of development. However, fears of excessive expansion of foreign capital exist; restrictions and limitations on foreign investment are subsequently imposed and work as disincentives.

In some countries, there are laws granting special allowances for domestic investors, *i.e.* a disincentive for foreign investors. The privatisation process can also discriminate against foreign investors. For example, coupon or voucher privatisation is open only to domestic investors.

Ownership rights to real estate property and land is often crucial for foreign investors. As a rule, expatriates can acquire *ownership rights to real estate* only through inheritance, for diplomatic representation, if the real estate in question has been acquired for the ownership of spouses when only one of them is a foreign expatriate, and a few other special cases for permanent residents.

Land ownership is even more restricted. In most countries, the ownership of land cannot be transferred to foreign expatriates. In addition, most constitutions in transition countries prohibit ownership of land or real estate by a foreign national. Liberalisation in the area of property rights is a sensitive question for political reasons; probably the most liberal approach towards land and real estate property is in Hungary. Recently, ownership of real estate has been made possible in most countries if legal entity is established.

Negative experiences with existing foreign investment, together with the lack of serious interest by foreign investors, were the reasons why governments, when approving some privatisation projects, preferred the so-called "Domestic Privatisation". A secondary reason advanced for this approach was "A Family Silver" argument, which has a social-political, rather than economic, background.

Table 3. **Foreign direct investment disincentives**

	Free ownership of land	Free ownership of real-estate	Sectoral restrictions
Bulgaria	no	no	yes
Czech Republic	no	no	yes
Hungary	no	no	yes
Poland	no	no	yes
Romania	no	yes	no
Russian Federation	no	no	yes
Slovakia	no	no	yes
Slovenia	no	no	yes

Source: Survey 1996.

Disincentives, like incentives, differ from country to country. For example, in Poland -- like Bulgaria or Russia -- political instability can be a disincentive (in Poland there have been six governments over the last five years). In Russia and in Ukraine, in addition to corporate tax and VAT

there are 12 other kinds of important state taxes. A large number of taxes can dissuade foreign investors who are used to paying taxes prescribed by the law.

In the long term, the taxation system plays an important role in the investors' decision-making process. A recent survey carried out by Deloitte&Touche Tohmatsu International among foreign investors investing in Central and Eastern Europe shows that **taxes** in the host country play the most important role in the investment decisions of the foreign investor. There were approximately 100 respondents, of which 50 MNCs, and many stressed the need for a stable and transparent legislative framework for investment. Half of the investors admitted that taxation influenced their decisions in a major way.

***Corporate tax and value added tax rates, by selected countries, 1996***

A reduced tax rate for joint-ventures often leads to the establishment of “fake” joint ventures for the purpose of tax avoidance. This has been documented by a sharp decrease in the number of joint-ventures in the Czech (Slovakia) Republic after the abolition of tax allowances for joint-ventures in 1991.

Table 4. **Corporate tax and value added tax rates (1996)**

	Corporate tax (%)	Maximum value added tax (%)
Bulgaria	35	18
Czech Republic	39	22
Hungary	18	25
Poland	40	22
Romania	38	18
Russian Federation	35	20
Slovakia	42	23
Slovenia	25	32

*Source:* Survey 1996.

The irrelevance of tax holidays which were (or are) usually provided during the first years of operation can be documented through the comparison of profitability of foreign enterprises. Average profitability is low in the case of foreign enterprises (and in the case of joint ventures, even negative). There is suspicion that profits are under-reported and transferred abroad before taxation. Transfer pricing is usually done by over-invoicing the imported material supplies (*e.g.* from the foreign mother company) and under-invoicing the exports back to their own foreign marketing subsidiaries. This has the same effect as an income tax holiday. Another explanation is that heavy investment was undertaken and thus caused losses during the first years of operation. This argument is supported by very high investment rates in the case of foreign enterprises. In the case where a company suffers losses, tax holidays are not sufficient incentives for the investor (see Table 4 in *Appendix I*).

Comprehensive tax reform is being undertaken in most transition economies. Measures include the implementation of a Value-Added Tax since January 1993 and the introduction of a personal income tax, with a combination of indirect taxes, direct taxes and taxes on property.

Tax deductible expenditures may be more important than the tax rate itself. *Value-added tax* is important and similar to tariff protection, but value added tax differences may influence trade patterns which affect the export performance of the enterprises and, consequently, the economy more than the tariff policy.

### 6. *Discriminative or equal treatment of domestic and foreign investors*

The arguments listed above contributed to the shift of equal investment incentives for both domestic and foreign investors. In general, only a few special **investment incentives** exist, of which most are equal for both domestic and foreign investors.

Table 5. **Investment incentives provided to all investors, domestic and foreign, 1996**

	Tax reduction, holiday	Other financial incentives	Non-financial incentives
Bulgaria	no	yes	no
Czech Republic	yes, but not significant	no	no
Hungary	yes <sup>1</sup>	yes	yes but not significant
Poland	yes <sup>1</sup>	yes	no
Romania	yes <sup>1</sup>	no	yes
Russian Federation	yes <sup>1</sup>	yes	yes
Slovakia	no	no	yes
Slovenia	yes	yes	yes

1. Under certain conditions, as for instance:

Hungary - minimum asset 200 million HUF, tax free for 5 years, max tax allowance 38%

Romania: According to Law no. 71/1994 companies registered after 1 January 1995 with a minimum capital of \$50 million, deposited in the company's bank account, carrying out in conformity with the company contract, industrial activities with a minimum 60% integration level in Romania and a minimum export share of 50% within the annual turnover, companies are exempt from corporate tax for a period of 5 years from the date of achieving profit, but not more than seven years from starting production.

Source: Survey 1996.

Only a few countries provide a general tax holiday for investors without limitation, such as minimum asset, turnover, etc. (this is the case for Hungary and Russia).

### 7. *Attitudes of foreign investors towards incentives*

Investors' decisions and the efficiency of capital allocation are influenced by both macro- and microeconomic policies. The ultimate factors are the total costs and estimation of future revenues.

Low labour costs in a host country, as compared to the country of origin, is considered to be the main attraction for investors. Total production costs and estimated risk are also major factors governing an investor's decision.

As illustrated by Table 3 in *Appendix I*, the decisive reasons given by Western investors for investing in Eastern Europe are political and financial stability together with market access. Benefits given to foreign investors are not considered, at least by the present survey, to be very important.

An investor invests abroad if he expects a higher rate of profit than in his home country and if new markets are easily accessible. Regarding the acquisition of a company, an investor can be suspicious and careful if faced with discount prices and/or special incentives in the transition country.

Little reliable information exists on the value of enterprises in transition economies. The investor takes a risk -- if there are losses instead of profits, tax holidays do not help. If labour is not skilled enough and produces a low-quality product, who cares if it is cheap?

If infrastructure, services, or telecommunications are poor, why should the investor play a role to receive a subsidy for capital expenditure? The asset should be cheap and the subsidy very high to offset political instability and a risky economic environment.

Investors' decisions to expand to another country or relocate production abroad are influenced not only by the situation and incentives in the host country, but also by the investment incentives and disincentives in the home country as well as other countries which come into consideration.

As a rule, for the reasons mentioned above, foreign investors were originally given preference over their domestic counterparts. Recently, however, there has been some hidden or open discrimination against foreign investors. They now compete against domestic investors who can lobby more effectively and have more knowledge of the domestic market. However, foreign investors usually do not need government guarantees on credits because they have a credit history, and domestic ones do not.

#### **8. *Government attitude towards FDI incentives***

In general, and in extreme cases, there are two possible government approaches to FDI. The first is an active (and discriminatory) one, which attempts to provide FDI incentives, various advantages, exemptions from general rules, and better conditions for foreign investors/enterprises with foreign equity ownership.

The second approach, which can be called "passive" and which is non-discriminatory, stresses the natural attractiveness of the country. Government activities and regulatory measures are directed towards the creation of financial stability and to the maintenance of social stability.

In the "passive" approach, incentives are provided through the liberalisation of trade and business activities, a step-by-step decreasing of the tax load for all investors (be they large or small, foreign or domestic), a more transparent legislation and its subsequent stabilisation. Such an approach does not give the bureaucracy the power to seek rents in their decisions as to whom to provide incentives. Last, but not least, is an increase in the role of the courts in business disputes.

A passive approach towards foreign investors can also indicate the existence of incentives for investors in the country, but these incentives are the same for both domestic and foreign investors.

The transition country most successful in attracting foreign direct investment has been Hungary, which received more than half of the capital invested in the area up to the end of 1995, even though FDI policy has often changed: government policies favouring foreign investors in the form of automatic tax exemption for foreign firms were in existence from 1990-1993, selective tax

exemptions for 1994, lower profit tax for re-invested profits in 1995, as well as negotiable individual tax exemptions for large investors and regional activities aiming at infrastructure subsidies. Since 1996, Hungary has been relying on indirect support, which takes the form of infrastructure subsidies, financial support from various funds, industrial parks, and financial and other support from local authorities negotiated on a case by case basis. For large investors, allowances in the form of protection of the market and custom relief are provided (compare Hunya and Sass 1996).

A high degree of foreign penetration, compared with other transforming economies, can also be observed in the Czech Republic, particularly in 1995. The conservative government, which came to power in mid-1992, abolished most FDI incentives and tends to treat all investors equally without any exceptions; *i.e.* Czech or foreign, strategic or “non-important”, in the case of the creation of a new enterprise or the operation of an existing enterprise.

The question can be asked as to whether the Czech Republic attracted less FDI than Hungary because of the government's reluctance to provide incentives -- selectively or automatically. The answer is probably no. There are several other explanations, of which the character of privatisation is one of the most important. Voucher privatisation has been the major method of privatisation in the Czech Republic -- a method which excludes foreign investors from the outset.

It is certain that the Czech government was not forced by its balance of payment situation (as was the case in Hungary) to attract foreign investors. On the contrary, the Czech Republic has been wary of large volumes of foreign investment over the last few years. Since 1993, portfolio investment and credits by foreign banks have started to accelerate in the Czech Republic. Due to the threat of high inflation, which could follow after a high influx of foreign exchange into the economy, thereby increasing the money supply, the government has not been favourable towards any FDI incentive policy.

As follows from the table below, an active approach, which indicates the existence of a special incentive scheme designed only for foreign investors, is less frequent among the governments in countries in transition. Most governments prefer a passive approach when offering investment incentives to both domestic and foreign investors.

Even though recent governments consider foreign direct investment important for the transformation and privatisation of the economy, because of its ability to supply technical and financial expertise and access to capital markets, most governments hesitate to approve special programmes for FDI support. They prefer either selective or case by case approaches. With the exception of Slovenia and the Czech Republic, all countries involved in the survey continue to provide selective financial incentives for foreign investors other than tax holidays or reductions.

As mentioned above, many countries which provided automatic tax reductions or tax holidays to foreign enterprises consider these incentives as questionable. Most countries today continue to provide fiscal incentives, but to all investors.

Although the history of transition economies is short, we can trace changes in their FDI policies. Legal systems are not fully developed yet and laws regulating economic activities are often changing. The perception of FDI policies and incentives by governments is also changing in most countries.

Table 6. **Recent investment incentives for foreign investors**

	Government approach to FDI incentives	Automatic FDI incentives	Selective incentives on case by case basis
Bulgaria	Passive approach	no	yes
Czech Republic <sup>1</sup>	Passive approach	no	no
Hungary	Passive approach	no	yes
Poland	Active approach	yes	yes
Romania	Active approach	yes	yes
Russia <sup>3</sup>	Passive approach	no	yes
Slovakia <sup>2</sup>	Passive approach	no	yes
Slovenia	Passive approach	no	no

1. Excluding the Slovak Republic.

2. Excluding the Czech Republic.

3. Since 1994, including CIS republics.

*Source:* National publications, Hunya (1995), Investment Guide for Bulgaria OECD CCET 1996.

After the collapse of central planning, countries in Central and Eastern Europe, as well as the former Soviet Union, were left with deteriorated economies, enterprises that needed deep restructuring, a lack of managers understanding financial and market relations, non-performing banking sectors, obsolete infrastructure, expensive telecommunications, etc. One of the key remedies recommended by post-communist governments was foreign direct investment, which was supposed to supply capital, credibility, know how, managerial skills, a new working moral, etc.

In order to counter-balance the disadvantages of the economy and increase the influx of foreign capital, governments provided generous “administrative” incentives. In the early 1990s, most countries were providing considerable incentives for foreign investors. Tax holidays for foreign investors were a general phenomenon.

Despite these incentives, the influx of foreign capital measured by the balance of payment data was rather modest in most Central and Eastern European countries as well as the former Soviet Union.

The situation has stabilised, however, in most CEE countries with respect to the liberalisation of markets, foreign trade and prices, and the privatisation of state-owned enterprises. Countries are developing their commercial banking, while central banks monitor inflation through the use of restrictive fiscal and monetary policies. Poland, Hungary, the Czech Republic and Slovenia now have convertible currencies. Thus, at least in the most developed countries of Central and Eastern Europe, the situation is starting to resemble that of established market economies. These countries also changed, or are going to change, their legislation towards foreign investors in relation to the Association Agreement.

Changes in the legal regulations of EU Association Agreements are aimed at gradually liberalising capital flows. New acts on foreign capital are being prepared simultaneously with the negotiation of association agreements. This places pressure on the adoption of provisions anticipating future obligations as regards a gradual liberalisation of capital movements and provides foreign investors with fundamental guarantees.

The movement of capital is regulated by EU Association Agreements. These agreements (Czech Republic, Hungary and Poland) bind contracting parties on the introduction of any new foreign exchange restrictions on the movement of capital (including FDI) and on the restrictions of existing arrangements. They also guarantee that associating countries will gradually introduce Community

rules on free movement of capital. However, the agreements do not set any obligatory deadlines as to the time of application of these rules. Looking at the problems with the liberalisation of trade and movement of production factors within EC countries, the achievement of a full liberalisation of capital flows between the Czech Republic, Hungary, Poland and the EC would seem to be a long-term process.

## 9. Conclusions

The survey relating to recent FDI incentives conducted among selected countries revealed:

- considerable differences between individual Eastern European countries in the existing FDI incentive schemes;
- a shift from an active to a passive approach;
- a shift from automatic to case-by-case FDI incentives;
- a shift from national to regional FDI policies;
- a higher integration of FDI incentives schemes into both general investment schemes and country legislation.

The factors contributing to a foreign investor's decision to invest are complex and multicriterial. *A priori* provided incentives or subsidies to FDI vary in the decision-making process. Thus, *a posteriori* evaluation on the efficiency of incentives is difficult because they cannot be separated from other factors influencing the performance and behaviour of the enterprise. Another problem in evaluation is the time frame: we cannot evaluate in the long term. Most deals have been closed only recently.

*Ceteris paribus* foreign direct investment (FDI) incentive policies can drive an investor's decision if investment attractiveness given by macroeconomic and political stability is achieved or other disincentives for investment are eliminated, which can be documented by numerous examples.<sup>2</sup> This, of course, is the case when, in the long term, investors expect growth and stability in the economy and the political system of the country.

In attracting foreign investors, more attention has to be devoted to the disincentives which deter foreign investors:

- high political/country risk, low economic stability;
- powerful trade unions, low working discipline caused by non-existent threats of unemployment;
- regulations and bureaucracy (discretionary legislation which gives powers to bureaucracy);
- ownership of land and real estate.

Not only is an FDI incentive scheme important, but so is the method of its enforcement. Data on government expenditure on FDI promotion is not available, making evaluation even more difficult.

It is equally difficult to measure the effects of FDI policies (as any other policy or government regulation) because the evaluator is usually a government official and the information is generally derived from a source which the government alone controls.

FDI incentives must not necessarily be seen as FDI promotion, but, for example, the consequent enforcement of the law on bankruptcy can work better than any FDI incentive. On the other hand, anti-trust laws with a strong anti-trust office can dissuade foreign investment.

Like any other investment, FDI can be successful or not and any generalisation of FDI performance is therefore difficult.

Legal systems are not yet fully developed and laws regulating economic activity are often changing, in particular those which apply to FDI. This is particularly true for Russia, where the legal investment environment still remains in a transition stage. Legislation is not only incomplete and inconsistent, but it is also not transparent.

Governments should avoid drastic swings in policy towards FDI because this increases the already existing instability of the conditions of operation of foreign capital in countries in transition.

Governments and parliaments have recently begun preparing new laws regulating the operation of foreign investors, with some intending to re-introduce FDI tax holidays and allowances: in Ukraine, a “New Law on joint-ventures”; in Poland, “On regulation of the foreign exchange”; and in Russia and Bulgaria, new legislation on FDI is pending. It is tempting for many of these countries to look for solutions to their economic problems in the form of special discriminatory policies, often by following the examples set by rich Western countries. The transition economies, however, are not wealthy enough to provide special incentives for special groups of investors. Each policy is costly, with uncertain and questionable returns.

## Notes

- 1 Howell (1995, p. 106) quotes the following statement: “There are only limited possibilities to improve return on capital employed in eastern Europe. The restructuring of companies takes an enormous time and pay-back will never reach the ratios we obtain through UK and US investment”.  
Some American investors, after having enquired about the conditions for greenfield investments in the Czech Republic and in the other CEECs, came to the conclusion that new investment is virtually impossible in that region due to the enormous bureaucracy and regulation of production, employment, taxation and trading.  
The stake of Air France, which invested in CzechoSlovakia Airlines, had to be re-purchased by the Czech government, while Air France had not fulfilled the expectations concerning restructuring and performance of the company.  
See Rojec M. et al (1995) for an overview of positive and negative consequences and spill-overs of FDI in CEECs.
- 2 According to Handelsblatt American concern “Advanced Micro Devices” will invest 2.8 billion DEM in the Dresden region (Eastern part of Germany). Out of this sum, AMD acquired the subsidy from the state budget of 0.5 billion DEM (from the fund for Eastern support), and 0.2 billion DEM interest allowance, 0.1 billion DEM contribution for the creation of R&D centre and credit guarantees for 0.4 billion DEM from the regional government and for 0.6 billion DEM from the state regional government. The attraction of complimentary or other high technology enterprises is expected as an effect of such a supportive policy.

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Appendix I

Table 1. Eastern Europe ratings (Euromoney)  
(March 1994)

Overall ranking	Economic performance		Political risk	Debt indicators <sup>1</sup>		Soviet credit rating <sup>2</sup>	Access to international finance markets <sup>3</sup>		Total
	25	25		20	20		10	20	
Max points	25	25	25	20	20	10	20	20	100
40	16.0	17.5	17.5	19.5	3.9	9.4	66.2		
Republic				Number of points					
44	14.8	15.6	15.6	18.5	2.3	9.5	60.7		
64	9.3	12.1	12.1	19.5	0.0	5.5	46.3		
73	12.2	14.9	14.9	10.0	0.0	6.0	43.1		
74	9.4	10.3	10.3	19.6	0.0	3.8	43.0		
80	13.2	11.5	11.5	9.2	0.0	8.0	41.8		
88	9.4	7.8	7.8	17.8	0.0	3.0	38.1		
138	6.4	7.3	7.3	10.0	0.0	2.3	26.0		
Federation									
Comparison									
2	22.4	24.3	24.3	20.0	10.0	20.0	96.7		
31	14.9	17.8	17.8	20.0	3.1	16.2	72.0		
38	17.8	18.0	18.0	19.6	3.9	9.5	68.6		
43	16.1	16.3	16.3	18.5	3.1	9.4	63.5		

Source: Euromoney; 1994 (3) 1. Two indicators (with 10 points each): Different indebtedness indicators and restructuring, 2. Sovereign risk as assessed by Moody's and Standard and Poor's (countries with no rating have value 0), 3. Total of 4 indicators (5 points each).

Table 2. **Foreign direct investment BOP statistics, aggregate stock, US\$ million**  
(1990-1995 cumulated, end of period)

	1990	1991	1992	1993	1994	1995 (estimate)	FDI stock per capita
Hungary	1 450	3 150	4 850	7 400	8 700	12 700	1 270
Slovenia	500	872	1 044	1 242	1 342	1 500	754
Czech Republic <sup>1</sup>	72	595	1 556	2 215	3 077	5 797	571
Poland	353	600	1 500	2 979	4 321	6 800	176
Slovakia <sup>2</sup>	-	-	231	366	552	700	131
Bulgaria	-	18	76	269	467	550	62
Romania	108	264	533	761	1 272	1 600	70
Russian Federation <sup>3</sup>	-	-	1 454	2 858	3 606	5 000	34

1. Excluding the Slovak Republic.

2. Excluding the Czech Republic.

3. Since 1994, including, CIS Republics.

Source: National publications, Hunya (1995), Investment Guide for Bulgaria, OECD CCET 1996.

Table 3. **Factors influencing FDI in Eastern Europe**

Banking	Factor	Points <sup>1</sup>
1	Political stability	115
2	Important domestic market	71
3	Financial stability	47
4	Skilled labour	40
5	Potential profitability	35
6	Geographical location	33
7	Competitive costs	28
8	Convertible currency	15
9	Transport system/infrastructure	10
10	Company law	6
11	Potential export base	5
12	Beneficial tax system	2

1. Three factors rated at 3.2 and 1 point.

Source: KMPG International Survey, 1993.

Table 4. **Selected indices of manufacturing firms under different ownership, Czech Republic**  
(1994)

	Greenfield enterprises (100% foreign owned)	Joint ventures	Domestic firms
Output/employee (thousand CZK)	1 013	1 083	686
Profit/output in %	14.94	-0.72	12.91
Value added/output	24.55	22.25	27.77
Profit/physical capital	13.53	-0.59	9.61
Average monthly salary in CZK	7 479	8 180	6 621
Average size (number. of employees)	161	285	295
Average physical capital (million CZK)	179 647	376 836	271 467
Investment/physical capital	21.39	18.6	6.37
Output/physical capital (%)	90.53	81.8	74.45
Physical capital/employee (thousand CZK)	1 119	1 324	921
Average depreciation in %	27.60	31.02	50.00
Debt/equity ratio	220.64	76.42	97.65
Export/sales	32.48	42.91	29.95
Profit/employee (thousand CZK)	151	-8.0	20
Export/employee (thousand CZK)	316	487	188
Investment/employee (thousands CZK)	240	239	59

*Source:* Individual enterprise data from balance sheets and profit/loss accounts, Czech statistical office, own computations.



## *Appendix II*

Following is the questionnaire designed for the purpose of the description of FDI incentives in countries in transition, from which tables 1-5 in the text are derived. The survey was carried out among local (country) FDI incentives' experts, at least two different sources in each country (for possible comparison and confirmation of information).

The following experts have been interviewed either on an individual basis or by mail or telephone interviews: staff of government agencies for FDI support (where they exist), researches/professors from academic institutions, government officials, business managers/foreign investors' experience in the country. The author would like to thank all persons interviewed for their kind assistance with the gathering of information as well as for completing the questionnaires.

The views expressed in this paper do not necessarily represent those of governmental bodies and full responsibility lies with the author.

This questionnaire does not intend to provide a detailed and accurate overview of FDI incentives. It should serve rather as an indicator or illustrator of a general approach towards investment strategy and FDI incentives in the countries involved in the survey. As is usual in the praxis, the situation is more complicated.

## Questionnaire on “FDI incentives”

1. **How would you characterise approach of the government towards foreign direct investment (FDI)**
  - government has active approach, trying to attract FDI by special incentives and preferential treatment
  - government has passive approach, no special treatment of foreign investors
2. **If incentives for foreign investor exist:**
  - incentives are provided on individual basis (case by case negotiations)
  - incentives are provided to all foreign investor(who apply for them or fulfil certain criteria)
  - both above cases exist (individual as well generally provided incentives)

### I. Incentives for foreign investor provided on case by case negotiations

1. **Are there incentives which are provided only for some important FDI**  YES  NO

If yes, please mark what incentives and under what conditions:

#### a) *Financial incentives*

- tax holidays
- grants or loans
- subsidy for capital
- subsidies for training, research and development or consultancy
- cash rebates for job creation
- profits re-invested in certain sector are tax-deductible
- (carry over possible)
- repatriation of profits possible
- customs relief for import of high technology provided
- subsidy for infrastructure exist (from PHARE money or state budget etc.)
- other (please specify)

#### b) *Non-financial incentives*

- protection of domestic market (by imposing import duty)
- exclusivity/monopoly guarantees (for telecommunication or other)
- other (please specify)

c) government prepared special incentive package for selected **sectors**  YES  NO  
if yes, please underline in which sector: infrastructure, high-tech activities, enterprises needing restructuring, other (please specify)

d) government (or local government) provides special incentive provide in certain regions (with high unemployment, special industrial zones subsidised etc.)  YES  NO

e) government provides in some deals discount in purchase price of acquired assets if foreign investor commit to maintain employment, invest in future , overtake environmental damages etc.  YES  NO

## II. Incentives for foreign investors provided to all foreign investors

1. **Special law, programme, incentives for all foreign investors exist**  YES  NO

2. **If tax incentives exist please mark what kind:**

- corporate tax rate reduction
- tax holiday provided

If tax-free years or concessions are provided (please specify):

- Minimum foreign holding..... (%)
- Tax free years .....
- Reduced tax rate ..... (%)

3. **Please mark what other *financial incentives* exist**

- grants or loans
- subsidy for capital
- subsidies for training, research and development, consulting
- cash rebates for job creation
- profits re-invested in certain sector are tax-deductible
- losses can be deduct next year/s (loss carry over possible)
- repatriation of profits possible
- customs relief for high tech technology import provided
- subsidy for infrastructure exist (from PHARE money or state budget etc.)
- other (please specify)

### *Non-financial incentives*

- protection of domestic market (by imposing import duty)
- exclusivity/monopoly guarantees (for telecommunications or other)
- other (please specify)

\* Are these incentives linked to the performance of foreign enterprise (productivity etc.)  YES  NO

\* Do the above incentive apply only for selected sectors or industries  YES  NO  
if yes, please underline in which sector(s): infrastructure, high-tech activities, enterprises  
needing restructuring, other (please specify).....

\* Special support for foreign investors in selected **region(s)** exist  YES  NO

\* Ownership of Land possible for foreigners  YES  NO  only with special approval

\* Ownership of Real Estate possible for foreigners  YES  NO  only with special approval

\* Sectors closed to foreign investors while open for domestic one exist  YES  NO  
if yes please underline: banking, public utilities such as railways, gas, electricity distribution,  
telecommunication, armament industry, other (please specify) .....

\* Any other discrimination of foreign investors exist (please specify) .....

### III. General investment incentives (both foreign and domestic investors)

1. **Existing rates of taxation (please give the numbers)**

- rate of the corporate tax ..... %
- value added tax ..... %

2. **If tax incentives exist please mark what:**

- corporate tax rate reduction
- tax holiday provided

If tax-free years or concessions are provided (please specify):

- Tax free years .....
- Reduced tax rate ..... (%)

3. **What other financial incentives exist (please mark)**

- subsidies
- grants or loans
- subsidies for training, research and development or consulting
- cash rebates for job creation
- profits re-invested in certain sector are tax-deductible
- loss in one year can be deducted from tax next year (loss carry over possible)
- customs relief for import of high technology provided
- subsidy for infrastructure exist (from PHARE money or state budget etc.)
- other (please specify).....

*Non-financial incentives*

- protection of domestic market (by imposing high import duty)
- exclusivity/monopoly guarantees (for telecommunication or other)
- other (please specify)

\* Are these incentives linked to the performance of enterprise (productivity etc.)  YES  NO

\* Do the above incentive apply only for selected sectors or industries  YES  NO

Please underline which sector(s): industry, manufacturing branches, agriculture health care, culture, education, infrastructure, transport, tourism

\* Are there special support for investors related to a special region exist?  YES  NO

\* Sectors closed (or access restricted) to all investors exist  YES  NO  
please underline which: banking, public utilities such as railways, gas, electricity distribution, telecommunication, armament industry, other (please specify)

## Chapter 6

### ADVANTAGES TO FOREIGN INVESTORS IN RUSSIA

by

E.L. Yakovleva

Senior Researcher, Institute of World Economy and International Relations

#### 1. The current regime for foreign investment. Is it a preferential one?

Foreign investors in Russia function nominally under national law. This regime was consolidated in 1991 by “The Foreign Investment Law in the RSFSR”. The principle of “national treatment” has been proclaimed in many political statements aimed at attracting foreign capital to Russia. However, since 1987 domestic and foreign investors found themselves in different legal and institutional environments. For example, many legal acts regulating the investment process, registration of foreign investment, and their governing bodies treat domestic and foreign investors unequally. That’s why it seems more accurate to define the current investment regime as a modified national one. There is enough ground to call it preferential as well, for foreign investors enjoy numerous advantages as compared to national residents, and most modifications deal with preferences given to foreigners. Nevertheless, one should be very careful while evaluating these definitions of the modern investment regime in Russia, for the situation is changing constantly. The regime for foreign investors changed drastically in 1987-1996. During this period there were noticeable fluctuations in the framework for foreign investors. This made it unstable and limited foreign inflows to the country. Recent years saw the growing similarity of both regimes. At present, domestic and foreign investors are subject to a regime located somewhere in between the two definitions described above. Simultaneously, this regime became in reality (and not only by words) more and more a national one. A number of important legal acts on investment activities, adopted recently, support this statement. “The Civil Code of the RF”, the law “On Production-Sharing Agreements”, and “The Comprehensive Program of Stimulating Domestic and Foreign Investment into the Economy of the Russian Federation” make no difference in the treatment of domestic or foreign investors.

What advantages does a foreign investor enjoy in Russia? What is our understanding of the term “advantage” in this sphere of activities? First, any preference to foreign investors as compared to domestic investors. Second, preferences given only to a certain group of foreign investors. Third, the elimination or softening of some existing restrictions. Thus, the term “advantage” in Russia means some preferences given to foreign investors, which are not applied to domestic businessmen, or any measure aimed at the elimination or weakening of existing restrictions in investment activities. Russia does not discriminate by extending advantages to some countries and discriminating against others. Exemptions from this general rule are inter-governmental agreements on double taxation or on the promotion of foreign investment in Russia.

Like many other countries trying to attract foreign capital, Russia makes wide use of fiscal and tariff preferences to foreign investors. All other forms and methods of attracting foreign investment are of minor importance.

These preferences and guarantees are provided by "The Law on Foreign Investment in the RSFSR" of 1991. However, many provisions of the Law have become outdated. Moreover, a number of its provisions, remaining legally in force, are not applied, for several laws have "corrected" this key law regulating preferences and guarantees in the investment sphere.

Contrary to this trend, several new laws and other legal acts, adopted between 1993 and 1996, introduced several new advantages and guarantees for foreign investors. Let us dwell upon the most substantial among them:

Imported goods used as a deposit to the statutory fund of the enterprise with foreign investment are exempted from custom duties and import taxes.

According to the Presidential Decrees "On Some Measures to Promote Investment Activity, *inter alia*, Carried out with the Attraction of Foreign Credit" N° 1199 of 10 June 1994 and "On Additional Measures to Promote Industrial Development, *inter alia*, Carried out with Attraction of Foreign Credit" N° 2168 of 24 November 1994 -- import of materials, equipment, machinery and intermediary goods for production development under contracts signed before 1 January 1993 and carried out within the framework of credit given to the RF by foreign states and international financial organisations, were exempted from VAT and customs duties.

If foreign investors import goods for an investment project valued at US\$100 million, or more, their customs duties are cut down by 50 per cent within a five year period. But to get this reduced rate they are to respect the following requirements:

1. Foreign suppliers are expected to be the incorporators of enterprises producing analogous goods in the RF;
2. Such enterprises should use local labour and raw materials;
3. They should invest into branches of material production;
4. The contribution of a foreign investor into the statutory fund of such an enterprise is to be no less than US\$10 million (see the Presidential Decree "On Additional Measures towards Attracting Foreign Investment to Implement Large-Scale Projects in Material Production Industries" N° 73 of 25 January 1995).

A growing direct financial support of state assets to private ownership is tantamount to granting them some preferences. The character of public investment under perestroika changed radically.

First, before economic reform, the state distributed all investment among public enterprises. Today public investment in the RF has declined dramatically. The RF Ministry of Economy forecast for 1996 values public investment at 1.5 per cent of the expected value of GDP. The bulk of investment is made by enterprises, many of which have become private. The contribution of enterprises to the total volume of national investment is growing rapidly and is foreseen for 1997 at 68 or 69 per cent.

Second, the state, while still investing in the public sector, began to put aside some resources for promoting private investors -- 0.5 per cent of GDP annually (see the Presidential Decree "On Private Investment in the RF" N° 1928 of 17 September 1994).

Third, old criteria of granting preferences gave way to new ones. Before, preferences could be granted on an individual basis or to a group of enterprises (branches), whose development was considered of paramount importance (priority enterprises and branches). In the last two years the state began to support private enterprises on a competitive basis. The purpose of this new policy is to choose the most effective economic projects without any preferences to companies, branches or regions. The investor selected at the auction may expect the state to cover up to 50 per cent of the total investment into the project; the investor himself must invest no less than 20 per cent of the project cost and find ways to attract the rest from outside sources.

The state support may take the following forms:

- a) Investment credit under LIBOR plus from one to seven per cent;
- b) State resources in exchange for enterprise shares;
- c) Guarantee of the Ministry of Economy on the total volume of loans. (see the Presidential Decree "On Private Investment in the RF" N° 1928 of 17 September 1994).

These examples are far from exhausting all the preferences a foreign investor may obtain in Russia. One can see from this list that there are many different advantages for foreign investors in RF.

## **2. Reasons for giving incentives to foreign investors**

The reasons for giving incentives to foreigners by Russia are obvious. The subjective reasons are the insufficient understanding by the Russian side that incentives have a secondary importance for the inflow of capital to the country compared to a favourable investment climate as a whole, and the strong interest of foreign and Russian businessmen co-operating with foreigners, in expecting these incentives in practice.

Objective reasons are even more serious. Russia at the time being needs foreign capital, and does not attract much (see Table 1).

Estimates of the Ministry of Economy of the Russian Federation for 1991-1995, which state that US\$7.86 billion and 1 272.2 billion roubles were invested in Russia from abroad, are more optimistic. It was mainly portfolio investment -- US\$5.53 billion and 1 032 billion roubles -- however.

It can be seen from Table 1 also, that Russia does not have the best results among the other former socialist countries and former republics of the USSR in attracting foreign capital. It is especially clear when we compare foreign capital inflows per capita. Some experts think that Russia has good prospects for attracting foreign capital, but in order to convert this potential into reality it needs to substantially improve the climate conditions.

It is clear that the success of some other socialist countries and former republics of the USSR, which are the main competitors of Russia on world capital markets, is the result of many factors, including the earlier and more successful implementation of economic reforms. But these countries

also apply incentives on a broad scale to attract foreign capital. So, Russia has to take this fact into account and try to give no less incentives than its competitors do.

Table 1. **Direct foreign investment in Eastern Europe**  
(US\$ million)

Countries / years	1994	1995	1990-95	1996-2000
Hungary	1 146	4 400	11 200	12 968
Poland	1 875	2 500	7 148	21 969
Czechia	878	2 500	5 666	15 466
Slovakia	187	200	775	2 150
Slovenia 87	150	501	3052	
Albany	53	75	205	583
Bulgaria	105	150	412	1 436
Romania	340	400	933	4 017
Other Balkan countries	120	100	300	2 210
Baltic states	430	400	1 280	1 890
Russia	1 000	2 000	4 400	26 960
Ukraine	91	113	574	1 400
Other CIS states	640	800	2 300	5 085
Eastern Europe	4791	10 475	27 140	63 847
Eastern Europe and former USSR	6 952	13 788	35 694	99 186

Source: "Finansovye izvestia", 29 March 1996. (taken from the "Economist Intelligence Unit").

### 3. Regional distribution of foreign investment: the main trends

The disintegration of the USSR and the emergence of Russia as an independent state brought about, among many other changes, a new role of the regions in the system of its foreign economic relations.

In Soviet times, only 11 administrative units of the RSFSR had a border with foreign countries. Now this number has increased to 35 (and to 43 together with coastal regions). Out of the 6 largest economic regions of the RF, only 1 -- Volga-Vyatka -- has no direct border. (see "Finansovye izvestia", 23 April 1996).

For many regions of the RF, foreign economic relations have become an important factor in solving their internal problems, including through the attraction of investment from abroad.

A marked feature of foreign investment in Russia is the high level of concentration in Moscow city and the Moscow region. In 1995, the capital city attracted 47 per cent of the entire volume of foreign investment in the RF, the Moscow region (excluding Moscow city) attracted seven per cent, Tatarstan 5.7 per cent, St. Petersburg 5.7 per cent, and Tyumen 3.6 per cent.

The causes of such a distribution are both objective and subjective. The first group includes the rich endowment of natural resources and a developed industrial infrastructure. Among the subjective factors, the most important is a relatively indifferent policy of some regions towards the attraction of foreign investment.

The central and regional governments have undertaken some steps to attract foreign investors to certain territories. For example, the “Law on Foreign Investment in the RSFSR” provides some preferences for foreign investors in the Far Eastern region(s).

In the early 1990s, many regions were engaged in establishing free economic zones (FEZs). All in all about 15 such zones were established. However, this method of attracting foreign capital to individual regions turned out to be rather ineffective. Only “Nakhodka” in the Far East and “Yantar” in Kaliningrad function more or less successfully.

There are reasons for the unsuccessful functioning of FEZs:

1. Misjudgement in determining the goals of FEZs. According to international experience, FEZs are established to develop foreign trade, to attract capital and technologies from abroad, and to solve some specific regional problems. The “fathers” of FEZs in Russia put to the forefront the task of achieving a greater scope of independence from the still existing inflexible command system in the national economy. This is the reason why some FEZs included vast territories (for example, the Leningrad and Altai regions) and were void of adequate resources for their development.
2. The attempts to establish FEZs were not supported by the necessary legislation. Until now, not a single law regulating the of FEZs (several draft on FEZs are debated by the State Duma) exists. The legal foundation for the establishment of a FEZ was a Presidential Decree. There were a number of clauses in this document that conflict with other Russian legislation.
3. Inconsistent policy of the central authorities toward FEZs. The measures promoting their establishment and functioning sometimes gave way to the policies impeding their development. Another factor retarding the inflow of foreign investment to the RF and its regions are the unsettled problems of dividing power and decision-making between the central, regional and local authorities. Related sources of problems include: ownership of property; an unclear status of federal natural resources; an inconsistency in granting foreign trade preferences and advantages to the subjects of the RF; and rules of distributing income from foreign economic activities and customs duties.

However, there have been some improvements of late in the distribution of foreign investment on the territory of the RF due to more active and consistent policies in some regions. This process is clearly reflected in regional law-making. Some republics of the RF

adopted their own laws on foreign investment providing for some additional preferences. For example, the Tatarstan law “On the Status of Approved Investment Project with the Participation of a Foreign Investor” (that came into force on 19 March 1996) grants tax preferences to projects over US\$100 000. The preferences include profit tax, VAT, and excise-duties relief, which are to be paid to the republican budget. Local authorities of Tatarstan also have the right to grant some tax exemptions.

In other regions, foreign investors can get some preferences, though there may be no special laws regulating foreign investment. In Khabarovsk territory, for example, foreign investors get local tax holidays for a two year period. Joint-ventures with foreign participation over 30 per cent, enterprises fully owned by foreigners, and enterprises investing over US\$5 million in the development of transport, production of construction materials, exploration and extraction of mineral resources are subject to this regulation (see “Finansovye izvestia”, May 16. 1995).

The “Comprehensive Program of Stimulating Domestic and Foreign Investment into the Economy of the Russian Federation” recommends to the corresponding executive authorities to work out regional investment programs with due attention to their specific conditions and making full use of accumulated experience. Such programs (provided they are up-to-date and thoroughly elaborated) may become an effective mechanism for attracting foreign capital at the regional level.

So, the general tendency in Russia is that the role of regional stimuli for foreign investment is growing.

#### 4. Restrictions to foreign investors in Russia

The impact of preferences on the inflow of foreign investment into Russia cannot be evaluated properly without taking into account the existing restrictions. There is no direct prohibition of foreign investment in the RF, but an investor should bear in mind the possibility of some limitations.

For example, “The Law on Foreign Investment in the RSFSR” demands the acquisition of a licence for starting activities in banking, insurance, or as a middleman in the movement of securities. “The Law on Insurance in the RSFSR” allows only the functioning of JV’s in the sphere of insurance.

According to the federal law “On Introduction of Addenda and Amendments to the RSFSR Law “On Banks and Banking Activities in the RSFSR” N° 17 of February 3. 1996 the volume of foreign banking capital is not allowed to exceed a certain quota, determined by a federal law, proposed by the Government with the advice of the Central Bank of the RF. Two years ago the quota was set at 12 per cent of the entire volume of bank capital in the RF. If the quota is surpassed, the Centre Bank stops issuing licences on the establishment of new banking enterprises, the enlargement of statutory funds of functioning foreign banks, and sale of shares to non-residents.

The Central Bank is authorised, when it is necessary, to address additional requirements to credit establishments with foreign participation and subsidiaries of foreign banks related to their capital base, financial statements, areas of activity, and the minimal level of statutory capital of newly registered banks. This right is given to the Central Bank of the Russian Federation by the law “On the Central Bank of the Russian Federation (the Central Bank)”.

Some restrictions concerning the participation of foreigners in privatisation exist. The State Program of Privatisation of State and Municipal Enterprises in the Russian Federation enacted by the Presidential Decree N° 228 of December 24 1994 says:

Foreign investors may participate in auctions and commercial and investment tenders. In concluding transactions with foreign investors, the seller of state and municipal property shall be represented solely by the relevant property funds (property management committees). Foreign investors may be admitted to the privatisation of trading, public catering, and public service enterprises and facilities, as well as small (with an average payroll under 200 employees or book value under one million roubles as of 1 January 1992) industrial, construction, and road transportation businesses only by decision of local governments or their authorised bodies. Any decision regarding the admission of foreign investors to the privatisation of any enterprises or facilities operating in the defence industry (with defence orders exceeding 30 per cent of total production), the oil and gas industry, the production and processing of ores of strategic materials, precious and semi-precious stones, precious metals, radioactive and rare-earth elements, transportation and communications shall be made by the Government of the Russian Federation or the governments of constituent republics of the Russian Federation (depending on the type of state ownership) concurrently with decisions authorising the privatisation of the said enterprises and facilities. After the auction (tender) its organisers shall deliver information on any successful foreign tenderers to the Governmental and Federal Security Service of the Russian Federation. Within a month, the Federal Security Service of the Russian Federation may present to the Government of the Russian Federation a justified recommendation that the said foreign investors shall be prohibited from the acquisition of the relevant stock, holdings, interests, or assets. On the basis of such recommendation, the Government of the Russian Federation shall adopt an appropriate decree. No foreign investment shall be used in privatising any state or municipal enterprises located within a closed territorial entity, except for such cases as may be provided by decrees of the Government of the Russian Federation. The participation of foreign investors in privatisation shall not be restricted in any other respect.

At so called pledge auctions (December, 1995) where the Government took credit from the banks as a pledge against shares of governmental enterprises, foreign participation in the auctions for some enterprises was forbidden. From 19 enterprises that were auctioned, there were such limits for 6 of them. What is more, they were the biggest and strategically most important for the economy, including “LUKoil”, “Sidanko”, “Norilskiy nikel”, “Novorossiyskoye morskoye parohodstvo”, “Murmanskoye morskoye parohodstvo”, “NK “Ukos”, “Sibneft”. After the end of the pledge auction, a special clause was inserted into “Ukos” Charter that prohibited resale or giving into trust the control to foreign investors for a ten-year period.

There are some restrictions for foreigners on the Russian market of government securities. For example, even at the beginning of this year the foreigners could acquire on auctions no more than ten per cent of the issue of short-term couponless bonds (GKO). A quota still exists, but it is set at 50 per cent on the auctions of GKO with longer periods of redemption. Such a policy is aimed at enlarging the sales. Another limitation relates to the transfer of money abroad, when acquired as a result of operations with securities. This limitation applies to both the volume of transfer and the level of returns.

Several recently enacted laws include controversial provisions that restrict foreign investors, and can even retard an inflow of foreign capital.

The law “On Production-Sharing Agreements” after discussion in the State Duma contains some strict, rigid clauses as compared to its draft. Now a foreign party in such agreements is faced with some unexpected problems:

1. It has to pay export duties;
2. The mechanism of introducing amendments to a working agreement is formulated in a such a way that it allows one of the parties to demand them in changing conditions;
3. The legislative power has now acquired more opportunities to regulate production-sharing agreements. The legislators have the final say in the agreements under the exceptional jurisdiction of the Russian Federation and in the agreements where the investor was not chosen through a tender or an auction.

The law “On Nationalisation” is under preparation. Its several drafts have different economic and political contents. The natural right of a sovereign state to nationalise is permitted under certain circumstances. Problems arise when it comes to:

1. The scale of nationalisation;
2. The reasons for it and are they well founded;
3. Compensation to foreign investors;
4. The methods of nationalisation.

The draft of the RF Government, for example, provides for compensation, when nationalisation is undertaken for reasons of environmental damage or of national security. The federal budget will contain, accordingly to the draft, a special clause on establishing a special fund to compensate the investors in case of nationalisation. The draft law prohibits the nationalisation of commercial banks, foreign property, land, and buildings. The list of objects which can be nationalised, is to be adopted annually by “The Federal Nationalisation Program”. It is expected that the Program will determine the scope of nationalisation and its procedures. Other drafts of laws on nationalisation differ considerably from the Government version. This is the reason why the adoption of this law can take a long time and one should be very careful in evaluating its chances of successful passage through the legislative bodies.

Summarising the problem of restrictions to the inflow of foreign capital to Russia, the following conclusions can be made:

First, the legal and economic environment in Russia opens many channels of avoiding, within the framework of the law, official limitations both for domestic and foreign investors. It becomes possible because of numerous “loop-holes” in legislative acts.

Second, the elimination or softening of restrictions (despite numerous evasions) will, like in other countries, initiate new flows of foreign investment to Russia. The admittance of non-residents to the markets of Russian state securities without any middlemen (in February 1996) resulted in the growing volume of operations in state short-term couponless bonds and long-term bonds.

The efficiency of such measures is often considerably higher than artificial stimuli. It is so because often the restrictions relate to spheres which are the most profitable and highly attractive to

foreign investors. Promotion measures, however, are applied usually in cases where foreign investors see no prospects of their activities in this or that country, region, branch and enterprise.

Now the corresponding authorities try to make the existing and would-be restrictions more systematic, and reduce their number and scope. Among these measures is the proposal to prepare a federal law "List of branches, activities and territories, where the functioning of foreign investors is prohibited or limited". This law may become an integral part of the above mentioned "Comprehensive Program of Attracting Domestic and Foreign Investors into the Economy of the Russian Federation". This idea seems rather fruitful, but the final result will depend on its implementation. If the law is short and clear-cut in wording, the declared target may be reached successfully. On the other hand, if ministries, committees and agencies go out of their way to assert their own interests, the outcome may be the opposite.

## **5. Balance of advantages and disadvantages**

A scrutiny of preferences and restrictions to foreign investment in the RF does not allow one to draw a final balance between advantages and disadvantages for the investors. The reason for this inability seems manifold:

1. There is a permanent process of introducing new preferences and new restrictions;
2. The life cycle of new arrangements is, as a rule, quite short and probably changeable;
3. Changes can be introduced by law, but this doesn't guarantee their implementation by acting parties;
4. Nowadays the balance between advantages and disadvantages depends critically on the political climate in the RF. The country is at a political cross-roads, and foreign investors do react to this situation very sensitively.

## **6. Impact of preferences on the inflow of foreign investment into the RF**

The general thesis about the minor, additional role of preferences as compared to the general investment climate of a recipient country is fully valid for Russia. In 1996 the inflow of foreign investment into this country is under the influence of the forthcoming elections of the President, a serious situation of the national economy, an underdeveloped stock market, and other macroeconomic parameters. Though preferences to and restrictions on foreign investment influence the inflow of capital from abroad, their influence is much weaker than that of the first group of factors.

An important method of attracting foreign investment is the elaboration of a legal framework, perfecting existing laws and drafting new legislative acts. The adoption of "The Civil Code of the RF", laws "On Production-Sharing Agreements", and "On Concession Agreements" (the latter passed the first reading in the State Duma) will, undoubtedly, contribute to the inflow of foreign investment as well.

Of no less importance is the shaping up of a well-functioning system of management and information. Under the Presidential Decree "On intensifying work on the attraction of foreign investment to the RF economy" N° 1108 of 29 September 1994. the Consultative Council on Foreign

Investment was set up. Its members are representatives of ministries and agencies of the RF and some large foreign investors.

Another step in the administrative sphere was the transfer of responsibility of state management of foreign investment to the Ministry of Economy. The latter is responsible for the newly-established Centre for Project Financing, State Registration Chamber, and Centre for Promoting Investment.

It's very difficult, and sometimes simply impossible, to evaluate the quantitative impact of the measures mentioned above on foreign capital inflows to the RF. In "The Comprehensive Program of Promoting Domestic and Foreign Investment into the Economy of the Russian Federation" the Ministry of Economy evaluates the effect of various stimuli to domestic and foreign investors on the total volume of investment in the RF. The Ministry forecasts a four per cent growth in 1996, seven per cent in 1997. Unfortunately, the methods of calculation are not known to the public.

We think that another evaluation of the same Ministry is of a greater interest. The Ministry asserts that the adoption of the law "On Production-Sharing Agreements" opens the way to the implementation of projects with a total volume of investment of US\$24 billion. This sum is many times larger than the accumulated volume of foreign investment to the RF for the last nine years. To date, however, the conclusion is that special measures to promote the inflow of foreign investment through preferences produce a relatively small impact on their volume.

In principle, it will be possible in the future to evaluate the effect of Information Offices established by the Centre for Promoting Foreign Investment in several industrial countries. However, they began their work recently, and the time is not ripe as yet to speak of any achievements.

The system of preferences for foreign investors in Russia has some specific features that reduce its efficiency:

1. Some preferences could be received by foreign investors under the condition of reaching of a very high threshold of investment or meeting many additional conditions. For example, the 50 per cent reduction of tariffs for imported goods mentioned above was received until now only by one foreign company -- the producer of chocolate -- "Mars".
2. Preferences given to foreigners in Russia are very unstable. For example, import of equipment as a contribution to the statutory funds of enterprises with foreign participation is periodically either exempted from taxes or taxed. The situation is the same with equipment imported for productive purposes: it knew the periods of exemption from taxes and customs duties and periods of their recurrence. Now both problems are solved in favour of foreign investors.

The institutional system is also unstable. Frequent reorganisations are detrimental to the confidence of foreign investors and their expectations to get necessary support. Discussions are under way on the expediency of having an independent agency which will bear full responsibility for the attraction of foreign investment. Now the management in this sphere is executed by a special department of the Ministry of Economy.

The instability in preferences, first of all, is connected with the whole instability in the economy, policy and organisation systems of this country. It is also important that the issue of preferences be closely connected with the revenue part of the country budget. Different economic and political interests come across at this point. A serious dilemma continues to

face the Russian State Duma and the Government: to raise revenue to the budget today by reducing preferences (including those given to investors), or to raise revenues in the future by giving investors some preferences today.

Russia has undertaken some measures to make the legal situation more stable. The Presidential Decree “On Perfection of Work with Foreign Investment” N° 1466 of 27 September 1993 does not allow conditions to aggravate for the activity of foreign investors on the RF territory for a three-year period by new normative acts. Unfortunately, this Decree, having the strength of a law, did not work, since it was not supported by the necessary administrative instructions and interpretations. Furthermore, the tax authorities were against its application.

Now the “Grandfather clause” is also included into the law “On Production-Sharing Agreements”. The law states, “if during the life-time of the agreement on production-sharing the RF legislation, the legislation of the subjects of the RF, or the legal acts of local authorities set new norms that deteriorate the commercial results for investors in the framework of agreement, the sides change agreement so that, to get results, that could be achieved the moment before the changes in legislation take place, on the moment of conclusion of the agreement”. However, to work properly the law must be consolidated through a set of administrative instructions and other legal documents.

3. The criteria for giving preferences are not evident. Not once the attempts were undertaken to reduce incentives given on an individual basis to investors. Unfortunately, these attempts, like many other measures toward foreign investors, were not consistent. Nevertheless, it is necessary to acknowledge that the number of individual incentives is now smaller than before.

For many years an idea to stimulate foreign investment in accordance with state programs of priorities for the development of the economy was discussed in Russia. This idea is still valid and is mentioned in “The Comprehensive Program of Stimulating Domestic and Foreign Investors into the Economy of the Russian Federation”. The problem is in the absence of a clearly articulated industrial policy of the country. That is why some attempts to stimulate, for example, the production of medicines, food-stuffs or other consumer goods, were based mainly on an empirical, rather than on a theoretical basis.

4. Legally adopted preferences did not always work in practice. FEZs is one example. Many reasons explain this situation. On the whole, they are the weak points in the Russian legal and administrative systems.

The theoretical conclusion about the minor importance of preferences in attracting foreign investment is valid at the Russian enterprise level too.

When an investor applies to the bank for investment credit, both sides calculate, first of all, the efficiency of the project as a whole, check for the presence of new technology and know-how, analyse the labour situation, etc. And only after that do they analyse the impact of incentives on project efficiency.

During the last two years, an institutional mechanism of state support for private investment took shape. However, the scope of cofinancing is quite scanty. In 1995. the state provided a much smaller

sum than was projected, and in the first quarter of 1996 cofinancing stopped completely because of the budget problems.

In summary, incentives to foreign investors have, undoubtedly, produced a positive effect on capital attraction, but the size was insignificant.

Russia will proceed with the imperfection of its legal and institutional framework to attract more foreign capital. The main directions of such activities are set by “The Comprehensive Program for Promoting Domestic and Foreign Investment into the Economy of the Russian Federation”. The Program provides for the creation of a favourable climate for foreign investors in Russia, measures to increase capital inflow from abroad, state support of investment activity, fine tuning the legal and institutional framework, and reducing the transaction costs to the investor. Proper implementation of these policies may lead to dramatic changes in Russia’s efforts to attract more foreign capital. But economic growth and stability could do even more.

*Chapter 7*

**BULGARIAN DOUBLE TAX TREATY NETWORK AS OF 26 SEPTEMBER 1996**

*by*  
Julia Varga  
Consultant, Price Waterhouse, Sofia

**Foreign investment incentives in Bulgaria**

In 1990, Bulgaria's centralised economy was given a market orientation. Along with other changes, it called for the introduction of laws which would change the nature of economic activity in the country. The preparation of new legislation led to long debates regarding the foreign investment policy of Bulgaria.

***Foreign investment policy***

After a six-year transitional period, the country's investment policy can be characterised as:

- neutral,
- not oriented towards incentives, therefore,
- not discriminatory in favour of domestic investors.

The main reasons for the very low level of incentives have been political and fiscal. Further to the forty-year history of incentives, given mainly on a subjective basis, the new governments have been consistently against incentives to both foreign and domestic investors. In parallel with this, Bulgaria has significant, for the size of its economy, external and internal debt. This explains the fiscal pressure against incentives.

The factors listed above could, therefore, hardly support the level of foreign investment which is still below US\$1 billion. In our experience, foreign investors' interests are attracted to a country by factors other than the existing financial and/or non-financial incentives.

***Other investment attractions***

Foreign investors, examining the political environment, find out that Bulgaria had six governments in the last six years. In addition, every new government has always made changes in the professional (non-political) staff which has inevitably affected the decision-making process. Furthermore, the implementation of new, market oriented legislation has been delayed.

As to the macroeconomic situation, most of the companies are still owned by the state. The structural reform including the privatisation and closing down of loss making companies is extremely slow, the banking sector is in crisis, and internal debt is increasing. The central bank interest rate is currently 108 per cent. (As of 24 September 1996 the interest rate was 300 per cent). GDP increased by 1.5 per cent in 1995. This year it will probably record zero growth or a drop. Private sector output is 15 per cent. Inflation had been forecast at 35 per cent, but is now already over 100 per cent. Unemployment is 11 per cent.

The overall bureaucracy, crime and corruption also adversely affect the business climate and make it difficult to develop a legal business in the country.

The size of the local market (a population of 8.5 million people) along with the efforts of neighbouring countries to attract investment complete the list of the foreign investor's considerations.

### **Incentives**

Foreign investment incentives can be financial, including fiscal and non-fiscal, and non-financial.

In Bulgaria non-fiscal incentives like grants for opening up of new working places, research or availability of preferential loans and non-financial incentives like provision of housing facilities, offering government contracts, etc. have never been introduced.

Nevertheless, since 1989 certain fiscal incentives in the direct tax and customs area have been introduced on a mainly non-discriminatory basis. However, no definite period of duration of these incentives has ever been set, and therefore, their eventual elimination has always increased the uncertainty of doing business in Bulgaria.

#### ***Fiscal incentives up to 1994***

In practice the following incentives were applied up to 1994. For corporate income tax purposes, the purchase of T-bills was tax deductible. In the Free Trade Zones a reduced profit tax rate of 20 per cent was applicable. None of these incentives became popular, either because the idea was too new and there was no confidence in the bills, or in the case of the Free Trade Zones, their infrastructure remained under-developed. This meant that the prospective investors, firstly, would have spent a significant amount of money for starting up a business, then he would have been in a non-profit making position for a long time, and therefore would not have been able to enjoy the fiscal incentives. In addition, there was no protection for those investments, *i.e.* the state could cause serious damage to the investor at any moment.

The third, available by law, incentive was a full tax holiday for certain activities. This exemption was supposed to be given by the Council of Ministers, but this has never happened in practice.

#### ***Fiscal incentives up to 1 July 1996***

Three popular incentives were available until July 1996:

1. The **first year capital allowance** had a significant role and was very popular. This incentive covered investments like buildings for production purposes, machinery and equipment, including computers, vehicles and non-material assets like software, know-how, etc.
2. The five year loss carry forward mechanism was a reasonable incentive by law. Unfortunately, the Tax Administration's understanding of this mechanism differed from the legal provisions and caused serious disagreement between the Inspectorate and investors.
3. The duty free import of machinery and raw materials was available only to foreign investors and only if the final products were exported later on. This incentive encouraged toll manufacturing in the country. This incentive was the only exception from the non-discriminatory policy of Bulgarian legislation with respect to incentives.

### *Fiscal incentives after 1 July 1996*

On 1 July 1996 the long expected new Corporate Income Tax Law was adopted to replace the old law and incentives. On that date the following incentives were implemented:

1. A five year **loss carry forward mechanism** has been more clearly defined, which will hopefully reduced the necessity of time (and money) consuming arbitration procedures in the future.
2. A three-year corporate tax holiday plus a reduced rate by 50 per cent for the following two years are applicable when the requirements listed below are met:
  - the company has been privatised;
  - the state share is below 33 per cent;
  - all payments regarding the privatisation deal have been made;
  - the net income is increasing;
  - 50 per cent of the saved corporate tax is reinvested in capital assets; and
  - all other taxes and social security contributions have been paid.

The current corporate tax rate is 36 per cent. In addition, all tax liable persons must pay a municipal tax of 6.5 per cent.

At this stage, the implementation regulations have not been completed or published yet. The term "net income" is still not clear.

3. The same fiscal incentive is available when along with or without the conditions described above.
  - the foreign participation in a company is more than 50 per cent and it is acquired before the year 2000.
  - the share capital of the foreign investor is above US\$5 million; and
  - the reinvestment of the saved corporate tax is more than 50 per cent.

An analysis of the newly implemented incentives shows that the law promotes privatisation rather than greenfield investment. The first year capital allowance has been eliminated and now the question is to what extent foreign investors, who have already invested, can find protection in the

current or planned changes in the Foreign Investment Law. In general, the current law offers protection against eventual changes in legislation. However it is not entirely clear how this protection will work in practice.

In conclusion, we can say that the current tax holiday regime calls for:

- significant investment in assets, training, know-how, licenses, etc.
- elimination of loss contributing factors, and
- careful planning of an investment.

### **Indirect incentives**

Bulgaria has a relatively good double taxation treaty and investment protection treaty network (see Appendixes 1 and 2). A careful planning of investments on the basis of these documents offers valuable savings.

### **Conclusion**

On the basis of our experience we can state that the incentives are of low interest to investors. From the investor's perspective the business environment, and political and economic stability are of higher importance. They are interested in continuous and consistent decision making, reliable legislation and its application and interpretation. Investors are encouraged when there is constructive dialogue with the government and its bodies.

The current domestic tax rate applied to dividends, interest, royalties and technical service fees in the absence of a treaty, is 15 per cent.

*Appendix 1*      **Bulgarian Double Taxation Treaty Network as at 26 September 1996**

The current domestic tax rate applied to dividends, interest, royalties and technical service fees in the lack of a treaty is 15 per cent.

The following is a summary of the main parameters of the Bulgarian Double Taxation Treaties.

Country	Dividends %	Interest %	Royalties %	Technical services %
Armenia (Note 1)	5/10	10	10	10
Austria	0	0	0	0
Belgium	10	10	5	5
China (Note 2)	10	10	10	7
Cyprus	0	0	0	0
Denmark (Note 3)	5/15	0	0	0
Finland (Note 4)	10	0	5	5
France (Note 5)	5/15	0	5	5
Germany	15	0	5	5
Hungary	10	10	10	10
India	15	15	15/20	20
Indonesia (Note 6)	15	10	10	10
Italy	10	0	5	5
Japan (Note 3)	10/15	10	10	10
Korea, Rep. of (Note 5)	5/10	10	5	0
Luxembourg (Note 3)	5/15	10	5	5
Malta	30	0	10	10
Netherlands (Note 7)	5/15	0	5	5
Norway	15	0	0	0
Poland	10	10	5	10
Portugal (Note 3)	10/15	10	10	0?
Romania (Note 3)	10/15	15	15	15
Russian Federation	15	15	15	15
Spain (Note 3)	5/15	0	0	0
Sweden	10	0	5	5/10
Switzerland (Note 3)	5/15	10	5	5
United Kingdom	10	0	0	0
Zimbabwe (Note 3)	10/20	10	10	10

1. The lower rate applies to dividends paid to a foreign company which is the direct owner of at least US\$40 000 of the payer company's capital.
2. The withholding tax on royalties for use (or right to use) industrial, mercantile or scientific equipment is reduced to seven per cent.
3. The lower rate applies to dividends paid to a foreign company which is in direct control of at least 25 per cent of the payer company's capital. In the specific cases of the different countries other requirements may be in place too.
4. There is no withholding tax on royalties for the use (or right to use) of scientific or cultural works.
5. The five per cent rate applies to dividends paid to a foreign company which is in direct control of at least 15 per cent of the payer company's capital.
6. There is no withholding tax on interest derived from public bodies.
7. Five per cent royalties are applicable in case The Netherlands apply withholding tax.

*Appendix 2*      **Bilateral Investment Treaties**

Albania	Hungary
Argentina	Italy
Austria	Luxembourg
Belgium	Malta
China	Netherlands
Cyprus	Poland
Czech Republic	Portugal
Finland	Slovakia
France	Switzerland
Germany	United States
Ghana	

*Chapter 8*

**FOREIGN DIRECT INVESTMENT IN SLOVENIA**

*by*

Mate Kovac

Director Slovenian Trade and Promotion Office

**FDI trends**

Up to the end of 1988, 28 joint ventures representing some US\$114 million of foreign capital had been created.

The more liberal foreign investment legislation, passed in December 1988 under the former Yugoslav Federation, together with a favourable attitude towards foreign investment brought an impressive wave of foreign investment into Slovenia.

By the end of 1994, FDI had risen to over 1 000 projects, with invested capital of US\$1.25 billion. This investment amounts to US\$627 per capita, which is second highest among the economies in transition, after Hungary.

Most investments in Slovenia have grown out of previously successful cooperation between foreign and Slovene business partners.

The European Union (EU) is the dominant source of foreign investment in Slovenia. 62.5 per cent of foreign capital originates from the EU, and it involves more than 700 companies out of the above mentioned total.

**The main EU investors are:**

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Austria	20.4%	262 companies	US\$155 million
Germany	15.5%	154 companies	US\$149 million
France	14.2%	6 companies	US\$124 million
Italy	10.0%	273 companies	US\$103 million
Denmark	1.4%	3 companies	US\$10 million
Other EU	1.8%	40 companies	US\$14 million

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*Source:* Bank of Slovenia, 1994

Croatia provides 31.7 per cent of foreign capital invested, which is the largest individual country share. This is the result of the economic ties left over from the former Yugoslavia.

Manufacturing is the most important recipient of FDI (49.6 per cent at the end of 1994), followed by electricity, trade and services.

### **The legal framework for investment in Slovenia**

All forms of investment enjoy full “national treatment” under Slovene law, *i.e.* they are treated in an identical way to domestic companies in terms of labour regulations, accounting, taxation, trade, custom duties, etc.

Wholly or partly foreign owned companies registered in Slovenia are indeed considered Slovene legal entities. All other factors, such as the source of capital, who owns the company, who has the majority or who exercises control, are irrelevant.

There are no restrictions regarding the legal status of foreign investors. Both foreign legal entities and foreign natural persons are allowed to invest in Slovenia. Also a foreign natural person can acquire the status of foreign investor regardless of the place of residence (even in Slovenia). The only obvious criterion is that he is not a Slovene national. The status of foreign investor can even be granted to Slovene nationals, provided that their permanent residence is outside Slovenia.

All sectors of the economy are open to foreign investors. The only remaining restrictions to date are applied to well-defined strategic types of activity, like the production of military equipment, rail & air transport, (tele)communications, insurance, mass media and auditing. The restrictions apply only to *wholly* foreign ownership.

All types of investments are open to foreign capital: joint ventures, greenfield investments, acquisitions, privatisation, concessions, contractual ventures, build-operate-transfer agreements, etc.

Partially and wholly foreign-owned companies and the acquisition of shares in existing companies have to register legally at the local court, like any domestic company. Any acquisition of substantial value (more than ten per cent of company book value or ECU 100 000 in Tolar equivalent) with a “socially owned” company (*i.e.* which has not yet been “privatised”) requires the approval of the “AGENCY”, prior to registration.

Foreign *legal entities* established and registered in Slovenia, regardless of their share in businesses, are “persons under Slovene law”, and therefore have the same ownership rights which domestic enterprises or Slovene nationals enjoy: they may own real estate.

In considering acquisition, adequate attention should be given to the Law on denationalisation, which in specific cases allows physical restitution of land and buildings to former owners of assets which were nationalised in the past. The process of restitution and compensation has indeed not yet been completed.

Foreign *natural persons* (individuals) and foreign legal (non-registered) entities are “persons of a foreign law”. They can *not* own real estate.

With a 30 per cent profit tax rate, Slovenia ranks among the *lowest in Europe in terms of the overall* tax burden.

## **Investment incentives**

### ***a) Corporate tax***

With a 25 per cent tax on profits, Slovenia has one of the lowest corporate tax rates in Europe. Slovenia is convinced that tax holidays and the like are not the most effective way too attract foreign investment. More effective incentives are believed to be political and macroeconomic stability, an open economy, a market-friendly legal framework, a skilled and relatively low cost workforce, and the strategic location of the country.

Therefore certain reductions of the above-mentioned tax base, in some cases, always apply to *both* domestic and (wholly or partly) foreign-owned companies or investors.

The tax benefits include:

- a reduction of the tax base by up to 20 per cent of the investment,
- for invested reserves, a reduction of up to ten per cent of the tax base,
- a reduction of 30 per cent of the first year's wages under certain conditions.

### ***b) Free trade zones***

Companies operating in designated Free Trade Zones are exempt from taxation on profits in the first five years, and for the part of profit generated by *exports* of goods and services.

A specific customs regime is being applied to these zones, including simplified customs procedures. Imports are exempt from duties; they become due only if and when the goods are transferred into a non-free trade zone.

Currently the free trade zones include the Port of Koper, Dravograd and Boraceva.

### ***c) Export/import incentives***

On the export side, no customs duties are levied. The Customs Act provides for a special export tax only on some strategic raw materials, *e.g.* lumber, timber, and some scrap raw materials.

Customs legislation also envisages the lowering of tariffs on certain imports, in order to stimulate the domestic economy, *e.g.*, exemptions for raw materials/intermediate goods for future export production, and lower duties on goods not produced in sufficient quantity in Slovenia.

### ***d) Employment incentives***

The government and municipalities provide some incentives to stimulate the creation of new jobs, employment of new entrants into the labour force, trainees and those who have been unemployed for more than six months.



## *Chapter 9*

### **CASE STUDY: BRITISH AMERICAN TOBACCO INDUSTRIES IN UZBEKISTAN**

*by*

Keith L. Silver

United States Commercial Service, Uzbekistan

#### **Introduction**

Most investment schemes involve a purely financial benefit to the foreign investor, however foreign investors may be attracted by non-financial incentives as well. This paper presents a case study of British American Tobacco (BAT) Industries' investment in Uzbekistan's tobacco industry. The paper provides background information on the company, the international tobacco industry, and the intense competition among Western tobacco companies for investment in emerging cigarette markets. After providing information about Uzbekistan's foreign investment program, priorities, and incentives, this case will identify the details of BAT's investment in Uzbekistan.

#### **BAT Industries PLC**

BAT Industries is one of the United Kingdom's leading business enterprises with interests principally in tobacco and financial services. The Group operates in more than 90 countries employing approximately 175 000 people. Major subsidiaries and affiliates include British-American Tobacco Co. Ltd, Brown & Williamson Tobacco Corp., Allied Dunbar, Eagle Star, Farmers Group, and Threadneedle Asset Management.

Once the world's number one tobacco giant, BAT is currently second in global market share slightly behind its biggest rival Philip Morris. BAT's vision is to regain the number one position in the world tobacco business within ten years fuelled by an intensive expansion into emerging cigarette markets around the world. In 1994, BAT acquired its one-time parent, American Tobacco, for \$1 billion thus giving it worldwide rights to produce and market Lucky Strike and Pall Mall cigarettes, two of BAT's most popular and profitable brands. This was part of a defensive strategy to guarantee the integrity of these international brands. Other international brands of cigarettes produced and marketed by BAT include: Benson & Hedges, State Express 555, Barclay, Viceroy, Kool, Kent, Belair and Hollywood. Sales from cigarettes account for approximately 60 per cent of group profits.

The Group made a quantum leap forward in 1995 with its best ever performance in tobacco. Sales rose by 18 per cent to 670 billion cigarettes and world market share increased to 12.4 per cent from 10.7 per cent in 1994. Exports in 1995 totalled 163 billion cigarettes, up 11 per cent, with good progress from international brands. Every region experienced growth with increases in both existing and new markets, particularly in Eastern Europe and Central Asia. According to BAT's 1995 Annual

Report, as of 1 January 1996, the strategic management of the Group's tobacco business has been brought under a single entity. Responsibility for operational decision making rests with five regions which were created to reflect the tobacco industry's international nature and BAT's need for maximum efficiency to compete on a global basis.

### **The international tobacco industry and competition in the emerging markets of Eastern Europe and the former Soviet Union**

The major tobacco companies have faced increasingly difficult challenges in industrialised nations. As part of government anti-smoking campaigns, many of these countries have enacted laws restricting public smoking and prohibiting of certain forms of cigarette marketing. Additionally, in some countries, government scrutiny is extending into the courts with charges that cigarette manufacturers have knowingly deceived the public about the dangers of smoking. Against this increasingly hostile backdrop, cigarette companies have seen the number of smokers in industrial nations decline at a rate of three per cent a year.

Overall, however, the global market for tobacco has been increasing. Statistics for 1994 estimate global tobacco consumption in that year at five trillion cigarettes, up ten per cent from the year previous. Most of this increase can be found in emerging markets where there are fewer marketing restrictions and people are more addicted. Faced with declining profits in the West, international tobacco companies have been scrambling for influence and market control in many emerging markets.

Eastern Europe and the former Soviet Union have been among the most lucrative new markets due to heavy per capita smoking and mass privatisation of state tobacco monopolies. Consumption in this region is estimated at 800 billion cigarettes a year compared to 500 billion in the United States and 400 billion in Western Europe.

BAT, Philip Morris, R.J. Reynolds, and Rothmans International have been the largest tobacco companies investing in the region. Other competitors include Austria Tabak and the German multinational Reemstma. In some transition economies the first company to enter into an agreement with the former state tobacco monopoly has had an advantage over other foreign competitors due to the acquisition of established local brands and production facilities. In most countries of Eastern Europe and the former Soviet Union, demand is still greatest for local brands.

The majority of privatised production facilities and locally grown tobacco are not yet up to standards that would allow for local manufacturing of the more profitable international brands. As economic conditions improve and demand for international brands increase, companies will begin to manufacture these brands domestically rather than cover demand through exports. Local production will also protect cigarette manufactures from the risk associated with actual or potential import barriers and help them build up distribution systems. For the governments of these transition economies, the heavy foreign investment in the tobacco industry has brought in much needed foreign capital, upgraded production facilities, and the transfer of technology.

There has been a feeling among the major international tobacco companies that a market that has been "there for the taking" will very soon be taken. Entering these markets as early as possible to buy up existing facilities and establish a market presence are seen as crucial steps. The sums that these companies are willing to pay to enter a new market are staggering.

Philip Morris has already invested over \$1 billion in the region as part of its strategy to buy up state industries in key markets. Its largest investment was \$420 million in April 1992 to acquire the entire Czech state-owned cigarette industry. It obtained five factories and 56 per cent of the republic's 21 billion cigarettes a year market. Following investments in Russia, Ukraine and Lithuania, Philip Morris declared in October 1993 that it intended to invest \$300 million in Kazakhstan for control of the republic's one manufacturing plant and to improve processing and production.

BAT has also been aggressive in its expansion in Eastern Europe and the former Soviet Union. BAT's manufacturing investments in this region currently exceed \$500 million with another \$500 million capital investment planned by 2000. Although it has thus far invested half the amount of Philip Morris, it has acquired more potential capacity than its competitors at a lower price per capacity. In 1992, for example, BAT made its first major investment in the region by acquiring 100 per cent of the Hungarian Pecs factory for \$35 million. Hungary has some of the world's heaviest smokers and through the popular local brand Sopianae, BAT has secured almost half of the Hungarian market share. BAT proceeded to obtain a controlling interest in Prilucky in the Ukraine in 1993 followed by strategic moves in Russia in 1994. In the past year BAT has commissioned a new factory at Marienbad in the Czech Republic and entered into a joint venture with Poland's PWT Augustow plant in a transaction valued at \$158 million. BAT's largest investment, however, was its agreement with the government of Uzbekistan in 1994 to pay \$61 million for controlling interest of the state-tobacco concern UZTABAK with a further \$233 million to be invested over five years.

#### BAT's main investments

Year	Country	Company	Projected shares %	Production capacity (billion cigarettes)	Eventual investment (\$ million)	Market size (billion cigarettes)
1992	Hungary	Pecs	100	15	35	22
1993	Ukraine	Prilucky	65	25	35	50
1994	Russia	Saratov	75	10	40	250
	Russia	Yavac	85	25	70	
	Uzbekistan	UZBAT	97	25	233	
1995	Poland	PWT Augustow	77	no data available	158	100

Source: Author.

## **The Republic of Uzbekistan: Foreign Investment Program, priorities and incentives**

Located in the heart of Central Asia, the Republic of Uzbekistan has tried to lure foreign investors through the development of a framework for the attraction of FDI. The Republic is the most populous state of the former Soviet Union after Russia and Ukraine with approximately 23 million people. Uzbekistan is the only state to border all of the other Central Asian republics, a region of approximately 50 million people, and it sees itself as poised to become an economic hub connecting Europe, China, the Middle East, South and Southeast Asia.

Uzbekistan has pursued a much slower and gradual transition to a market economy than that of many other Newly Independent States. This policy decision has come directly from Uzbekistan's President Islam A. Karimov, an active player in transforming the economy. While criticised by many foreign economic observers as being too slow, President Karimov has maintained that a gradual transition is preferable to "shock therapy" in order to guarantee political and social stability.

The government perceives foreign direct investment as an important ingredient in transforming the economy and has sought to develop the optimal FDI framework. After initial "trial and error" experimentation enacting laws and regulations, the government established more carefully thought out policies made in consultation with international organisations. In 1994, several laws and presidential decrees were created to liberalise Uzbekistan's FDI policies more in line with common standards.

The objectives of Uzbekistan's investment programme are to accelerate growth and facilitate structural change. The economy is heavily skewed towards a cotton monoculture, mining and heavy industry. It is weak in the production of consumer goods, the processing of raw materials and in retail trade and exports. Goals are to increase overall production, especially in basic foodstuffs and consumer goods, increase local value-added from both agricultural production and resource extraction, and increase Uzbekistan's export potential.

The Investment Programme attempts to create favourable conditions for foreign investors in key priority areas. These priority areas are:

- production of consumer goods using advanced technologies;
- agricultural processing;
- establishment of a modern telecommunication infrastructure;
- development of tourism;
- electronics;
- production of resource and energy-saving equipment;
- production of pharmaceuticals and medical equipment;
- environmentally friendly mining and metal processing;
- introduction of environmental protection facilities in existing enterprises;
- processing of industrial and consumer wastes.

The Government of Uzbekistan has a policy of offering FDI incentives, however, these incentives have sometimes been inconsistent and at times have lacked transparency. There now appears to be a number of financial incentives in place that are automatically granted. Most notable

among these is a five year tax holiday granted to joint ventures with more than 50 per cent foreign ownership that produce consumer goods. Non-financial incentives, particularly ones that provide preferential treatment, have been discretionary and often involve large investments.

### **BAT Industries investment in Uzbekistan**

Prior to BAT's entry into Uzbekistan in 1994, UZTABAK, the republic's state-owned tobacco enterprise, consisted of one inefficient manufacturing plant in the capital city of Tashkent that produced oval shaped cigarettes using low quality oriental tobacco grown domestically. The plant had a production capacity of seven billion cigarettes per year, however, in 1994 only 3.3 billion were produced and of that number, only 1.3 billion left the factory in packs. With a domestic market estimated between 17 and 20 billion cigarettes per year, the republic is heavily dependent on imported cigarettes.

The tobacco industry in Uzbekistan employed not only people in manufacturing, but also a significant number of small farmers. 60 per cent of the population is employed in agriculture, mostly in cotton, but there are also approximately 60 000 farmers producing about 40 000 tons of tobacco per year. As with cotton and many other raw materials, most tobacco had been exported to manufacturing facilities in Russia and Ukraine.

BAT began working with the Government of Uzbekistan in October 1993 on a plan for the development of Uzbekistan's tobacco industry. October 1993 also happened to be the time when BAT's biggest rival Philip Morris announced its plans to invest in neighboring Kazakhstan's tobacco industry. After several months of negotiations, BAT made an announcement in May 1994 that it had reached an agreement on its participation in the development of the tobacco industry.

Under the terms of the agreement, BAT acquired 51 per cent of UZTABAK for \$61 million. The new venture was renamed UZBAT. BAT agreed to invest \$233 million more over the subsequent five years to modernise the existing cigarette factory in Tashkent; build a new cigarette factory near Samarkand; invest in tobacco fermentation plants in Samarkand and Urgut; provide training and technical services and invest in the industry's social infrastructure. As capital is invested, BAT's equity interest will rise to 97 per cent. BAT received rights to local brands and the opportunity to locally produce value-added international brands. BAT's priority is to increase the quality and quantity of Uzbek-made cigarettes. Within five years total cigarette output is expected to rise to 25 billion per year exceeding domestic demand. Excess cigarette output would be exported and markets may also be sought for upgraded tobacco leaf.

Incentives offered by the government as part of this agreement include a five year tax holiday, no import duties on materials for the production of cigarettes, the ability to repatriate profits, and a five year manufacturing exclusivity right. These first three incentives would have been granted automatically under existing legislation. The five year manufacturing exclusivity right was discretionary and would fall under the definition of a non-financial incentive.

Although BAT has exclusive manufacturing rights, it has no monopoly on the market. There are approximately 70 brands available including some allegedly smuggled from Kazakhstan. According to UZBAT Managing Director, Jim Rowlands-Rees, BAT initially could not compete with imports on price, because imports were allowed tax free, while locally produced cigarettes were subject to a stiff

excise tax. That problem was solved when the government also began to impose an excise tax on imports, allowing BAT the freedom to roll out a new national brand called Seraton.<sup>1</sup>

It is not clear what guarantees were provided by the government to ensure that BAT would have a five year manufacturing exclusivity right. One way that this could have been done would be for President Karimov to codify the terms of the agreement in a presidential decree. This has apparently been done for other high profile investments like those by Newmont Mining and Lonhro. Several reports indicate that the largest foreign investors have sought out this form of Presidential approval for a degree of confidence that the rules of the game will not be changed overnight.<sup>2</sup>

The President and Deputy Prime Ministers Utkur T. Sultanov and Viktor Chzhen were actively involved in negotiating an agreement with BAT. When managers of UZTABAK resisted BAT's desire for a controlling stake in the company, President Karimov reportedly intervened to nudge the deal along. Hoping to use this large deal as an investment showpiece, UZBAT's Finance Director, John Selby said that President Karimov "pushed through a number of sticking points".<sup>3</sup> BAT reportedly spent \$1 million in legal fees clarifying every aspect of its operation.<sup>4</sup>

It is not clear what effect, if any, incentives played in BAT's decision to invest in Uzbekistan. Because of the highly competitive nature of the international tobacco industry and the desire among these companies to establish a market presence in new markets, it appears that incentives would have had little impact on corporate decision making.

### Notes

1. Sharon Reier, "Uzbekistan Hopes To Strike It Lucky Economically", International Herald Tribune, 9 October 1995.
2. Euromoney, September 1994 and Business Week (International Editions), 19 June 1995.
3. Business Week (International Editions), 19 June 1995.
4. Financial Times, 31 May 1995.

## *Chapter 10*

### **SKODA AUTO-VW REVISITED<sup>1</sup>**

*by*

Alena Zemplerova

Center for Economic Research and Graduate Education, Charles University, Prague

#### **Summary**

In 1991, Volkswagen created a joint-venture with the Skoda car company. In addition to incentives provided by the existing laws on foreign direct investment, the Czech government provided additional tax exemptions and honoured special requests of Volkswagen which concerned conditions usually found in market economies. In their agreement with the government, Volkswagen was also asked to make certain promises and commitments for investment. This study describes and evaluates the incentives provided by the government and the fulfilment of Volkswagen's commitments from the perspective of five years of operation of the joint-venture.

During the last five years, the Czech government has changed its attitude toward foreign direct investors. With this change in attitude has come a shift in legislation, a change in the taxation system and in the overall business environment in the Czech Republic (CR). In many respects, the exceptional treatment of Volkswagen has been extended to all investors. The corporate tax has been gradually reduced, VAT introduced, and the currency made fully convertible.

Until 1992, all markets were protected by import surcharges and a fixed foreign exchange rate. International agreements such as General Agreement on Tariffs and Trade (GATT) and the European Union Association Agreement also limit concessions and market protection for foreign investors. Nevertheless, the car market continues to be protected by a higher-than-average customs tariff. The efficiency of this protection is nevertheless limited in practice by the importation of used cars.

Volkswagen itself did not take advantage of a tax break during the period it made losses. Volkswagen's investment commitments have been reduced and investments re-oriented. Similarly, promises concerning output and employment were modified. On the other hand, thanks to Volkswagen, SKODA products became competitive on the world markets and thus contributed to the export performance of the economy.

This experience shows that, not the concessions but rather the macroeconomic stability and general business environment in the host country, and foreign management skills, contributed most to the success of the foreign investment in the Czech car factory.

## **Introduction**

Volkswagen (VW) created a joint-venture with Skoda on 16 April 1991 in the form of a joint stock company. Skoda Mlada Boleslav contributed physical assets, for which the Czech government obtained 69 per cent of the enterprise equity. At the time of the contract's signature, Volkswagen acquired a total of 31 per cent of the enterprise equity for DM 620 million. According to the contract, VW acquired another 39 per cent of the equity in two subsequent payments; in 1994 (DM 390 million) and 1995 (DM 390 million). Presently, VW holds 70 per cent and the Czech state 30 per cent of the equity of SKODA Auto.

In 1991 SKODA-VW received several important discretionary incentives -- both financial and non-financial -- from the government and Volkswagen made several promises and commitments.

In 1996, five years later, the reality can be compared with the promises made in the agreement between the Czech government and Volkswagen in 1991. This study's aim is to assess the role of incentives in the decision-making and performance of the company.

## **Government and Skoda-Volkswagen**

At the request of Volkswagen at the time of closing the deal, the Czech Government stated that:

1. The debt of seven billion Crowns will be written off and the government will cope with the former owners of physical assets of the company, as well as with possible environmental damage, so that it will not have a negative influence on the Company.
2. In spite of being the majority shareholder, from the very beginning of the creation of the joint-venture, the Czech government will not interfere in the price policy on domestic as well as foreign markets for all products and services. Control of the company will be fully and without any restrictions in the hands of VW and its German managers.
3. The government will comply with the demand from VW for a change in the tax system which placed a 29 per cent turnover tax on each SKODA car while the customs duty on imported cars was only 19 per cent.
4. The government grants SKODA a two-year tax break and the future tax burden is limited to a maximum of 40 per cent. SKODA will also receive preferential treatment on depreciation.
5. Covering of losses from future profit during the following five years will be possible without any limitation and further conditions.
6. The company will receive an exemption from its duty to supply free convertible currency to the State Bank and thus be able to open a foreign currency account. The State Bank agreed to provide permission for acquiring credits from foreign banks.
7. The state will cover the expenses for enlarging and improving the telecommunication system by enlarging the capacity of connections between the Company and the telephone exchange by the end of 1991.
8. The government (the local labour office) will cover part of the cost of re-qualification of the Company's employees.

From the overview, it follows that VW requested conditions which would counterbalance handicaps of the former planned economy in the field of banking and infrastructure. In fact, VW required from the government to create conditions usually found in market economies at that time in the field of finance and telecommunications.

### ***Clearing the debt and old burdens***

One of the conditions of Volkswagen for the investment in SKODA was to join a company which would not bear any burden from the past: no old debts, no environmental damage, no restitution claims. While there existed only minor problems with environmental damage and restitution claims, the problem of the debt was crucial.

In 1989, the Skoda Mlada Boleslav car factory was highly indebted after large investments in a new modern production line. In 1991 Skoda Mlada Boleslav had a debt of 7 billion Czech Crowns (CZK) (approximately DM 320 million in the respective year's exchange rate), which made it nearly insolvent. In turn, this affected its suppliers, threatening them with bankruptcy. Skoda Mlada Boleslav was unable to generate sufficient internal profits for investment in new technology, to increase capacity, or to acquire outside finance.

The Government was, in general, hesitating to write off the debts of the companies prior to privatisation. Nevertheless, the Ministry of Industry exceptionally agreed with the Ministry of Privatisation that the debt would be partially liquidated from the assets of the National Property Fund.

Technically the CZK 7 billion debt of Skoda in 1991 was transferred (or retained by the state enterprise PRISKO and STASKO Skoda Mlada Boleslav, when the financial and organisational restructuring of the company occurred. Recently the debt has decreased to about one half and is in the hands of Konsolidacni Bank -- a state owned bank).

Clearing the debt from the books of SKODA created a good position for the government in bargaining the purchase price. The asset valuation of SKODA Mlada Boleslav was DM 800 million<sup>2</sup>. There was a large difference between the asset evaluation of DM 800 million as made by the accounting firm and the final price determined by the bargaining process - which was almost twice the valuation result (DM 1.4 billion in three payments during 1991-1995, of which DM 1.2 billion directly to the company's capital).

It allowed a radical improvement in the financial situation of the company, which would otherwise have had to serve this debt and acquire cheaper credits in the future.

### ***Control of the company***

In 1991 management and labour organisation was poor and capitalisation of the enterprise was low. There were no financial analysts nor controllers or marketing specialists in the old management.

Being fully endowed with the responsibility and power to make changes in the control of the company, Volkswagen sent a specialist and managers to SKODA Mlada Boleslav.

Major changes in enterprise management have taken place since the establishment of the Skoda-Volkswagen joint-venture. There is a Czech chairman of the board of directors, the

vice-chairman is German. The board of directors has five members, of which three are German citizens and two are Czech citizens. The second Czech representant is head of the Personnel Department. The supervisory board has ten members, four are Czech citizens (of which three are representatives of trade unions and one a representative of the Ministry of Industry and Trade).

The system of control as well as the organisational structure has been changed according to Volkswagen practices.

The number of Germans working in the factory increased from 50 by November 1991 to 140 recently. These employees are highly qualified managers, who work for the same or higher salaries than in Germany.

The process of change in the control of the company has been rather profound: marketing, personnel and product development, and manufacture were the main factors in improving competitiveness. The first goal of the company's management was to achieve low cost and high quality without a large production volume and a large investment.

### ***Market protection***

As part of the effort to create a competitive market economy, in January 1991 parliament passed the Competition Protection Act. The law is similar to the legislation of the European Union and the German Anti-Cartel Law. According to this law, "the dominant position in the market is held by an entrepreneur who supplies the relevant market in the course of the calendar year with at least 30 per cent of supply of identical, comparable or mutually substitutable goods"<sup>3</sup>.

There were two accusations made concerning SKODA Auto because of monopoly abuse from the Ministry for Support of Competition: first in 1993 for an increase in price, and second for speculation with the deficit of spare parts in 1994/1995. Originally, penalties had to be paid but SKODA was always strong enough to defeat the accusation of the Ministry.

SKODA Auto is in fact the only important personal car producer in the Czech Republic. Output of TATRA is negligible -- no more than several hundred cars per year.

SKODA Mlada Boleslav already possessed a monopoly position in 1989, when it had a total output of 188 317 cars, and total imports were 39 992, of which 35 954 cars were from other Central and East European countries.

At the time of creation of the joint-venture with VW, the share of Skoda Mlada Boleslav in the sales of automobiles in domestic markets was about 90 per cent. Nevertheless, since 1991 its share on the domestic market has been continuously decreasing.

The number of imported automobiles -- both new and used -- has been increasing. In 1995 the SKODA car company's share in the personal car domestic market was about 65 per cent. When imported used cars are incorporated into the calculation, the share of SKODA decreases to a mere 36 per cent for 1995.

**Table 2. Domestic production and import of personal cars**  
(1993 - 1995)

	1993		1994		1995	
	Number of cars	Market share	Number of cars	Market share	Number of cars	Market share
New personal cars	25 964	14.0	41 795	17.8	46 615	19.5
Used cars	89 691	48.5	119 511	50.9	106 225	44.5
Domestic sales of SKODA	69 311	37.5	73 369	31.3	85 873	36.0
Total domestic market	184 966	100.0	234 675	100.0	238 713	100.0

*Source:* Statistic of the car industry, Czech Republic and Slovak Republic.

A customs duty is imposed on private imports (individual or by an organisation), but it is calculated from the reported sales price abroad. This can be easily manipulated and importers of second-hand cars effectively evade custom duties and VAT (which is computed as 22 per cent of the sales price plus custom duty).<sup>4</sup>

The reported average import price of used cars was about CZK 30 000 in 1994.

**Table 3. Price development of selected cars on the Czech Market**  
(1993-1996)

Type	Current price 1993	Current price 1996	Decrease in price (%)**
Ford Fiesta C1.1	445 030*	270 718	62.0
Seat Toledo 1.9 CL	534 230	433 140	44.2
Mazda 628 1.8LX	618 000	548 870	38.8
Opel Astra GLS 1.6	463 073	409 900	37.4
Ford Mondeo 1.6	570 528	523 380	36.8
VW Vento 1.8 GL	549 516	529 238	33.8
Lada Samara 21099	226 200	267 200	18.6
Skoda Favorit/Felicia	136 800	219 900	0

\* Price 1992.

\*\* decrease in price is computed with involvement of inflation which was about 45 per cent between 1993-1995.

*Source:* Czech Ministry of Finance, 12 April 1996.

Competition on the domestic market is rather sharp, causing a decrease in the price of imported cars by one to two thirds since 1992. Thus, SKODA's competitors were still able to compete with a low cost of production and low price increases. SKODA increased the price by the inflation index between 1992-1995.

During the early stages of transformation, the government continued to protect domestic markets from foreign competition. Up until 1992, there existed an 18 per cent, then a 15 per cent surcharge on imported goods, import licensing and further limits on foreign trade liberalisation. A rather high devaluation of the Czechoslovak currency by the end of 1990 also contributed to protect domestic producers (CZK 30 = US\$1). A general protection of the markets was achieved through a policy of fixed exchange rate of the crown. Nevertheless, since 1993 the import surcharge has been removed and the Czech crown has been appreciating continuously. Meanwhile, the exchange rate has been floated at 15 per cent.

In general, and in the long term, the establishment of a competitive climate can be aided only by opening up the economy to foreign competition.

Czechoslovakia participated in the Uruguay round of GATT and negotiated the Association Agreement. After the split of Czechoslovakia in 1992, a Customs Union was established with the Slovak Republic in 1993 and further efforts were made to eliminate discrimination in trade liberalisation with other Central and East European Countries. Several bilateral free trade agreements, as well as the Central European Free Trade Agreement, have been signed.

The legal framework of the Czech Republic's customs law is very similar to that of the European Union's. Minimum non-tariff barriers to trade still exist. The import/export regime of the Czech Republic can be described as relatively liberal and transparent. Moreover, if the extensive use of preferential rates is taken into account, the average tariff rate for 1995 can be estimated at only 3.8 per cent.

Nevertheless, cars are considered by the government to be "sensitive products" and import tariffs are usually above average. The car market in the Czech Republic is still protected by tariffs, as illustrated by Table 1 in the Appendix. SKODA still enjoys a certain asymmetry in the customs tariffs based on the GATT agreement.

In 1996, an 11.4 per cent tariff was imposed on cars from the European Union, and a 19 per cent tariff was imposed on cars from other GATT countries. Protection by custom duties is decreasing every year and, according to the GATT agreement, the import duties on cars should be abolished by the year 2001. Nevertheless, car markets are always subject to re-negotiations.

Protection of the domestic market was also created through a higher VAT. At present, VAT in the Czech Republic stands at 22 per cent, which is still above the EU average and thus promotes exports while preventing imports.

Skoda is able to compete not only through the price of the car, but also with lower prices of spare parts, services and insurance.

SKODA Auto not only produces SKODA cars but also sells VW group products. In 1995 there were more than 14.5 thousand VW, AUDI and SEAT sold on the Czech market. The total share of the VW group in imported new cars in the Czech market reached 26 per cent. Thus, protection of the domestic market can be counter-productive for imports of the VW Group.

Table 3. Comparison of selected parameters of SKODA and imported cards

Car	Price (CZK)	Price of spare part (CZK)	Insurance price (CZK)	1 hour of services (CZK)
Daewoo	219 900	985	16 204	215
Fiat Punto	235 000	1 652	18 267	415
Lada Samara	233 900	1 688	7 116	140
Open Corsa	234 900	3 330	14 888	340
Skoda Felicia	219 700	1 115	6 476	190

Source: Auto Tip 1996.

The strategy of SKODA is oriented towards export; two-thirds of the SKODA output goes to export, while only one third is sold on the domestic market. As follows from the table, exports from the Czech Republic for the period 1991-1995 were higher than imports.

Table 4. Sale of cars SKODA

	1990	1991	1992	1993	1994	1995
Total production	186 000	172 209	199 682	219 158	174 000	211 042
CR+SR	66%	28%	48%	44%	36%	38%
CEECs	10%	41%	13%	13%	12%	11%
West Europe	22%	30%	30%	28%	35%	37%
Overseas and other	2%	1%	9%	15%	17%	14%

Source: Skoda, automobilova a.s.

Table 5. Sales and prices on the domestic and world markets

	Sales revenues	Number of cars	average price per unit (CZK)
Sales in CR*	21.1*	87 858	
SKODA cars	15.6 billion CZK	74 063	210 600
Imported cars**	5.5 billion CZK	13 795	398 700
From exports	22.8 billion CZK	136 913	167 800 ***

\* including imported cars

\*\* VW 7 638 cars, SEAT 5 507 cars and AUDI 650 cars for total about CZK 5 billion - according to data from the Association of Car Importers.

\*\*\* sale price of the SKODA Felicia 1.3 L is on the domestic market CZK 219 900 (basic equipment) and the same model is being sold in average for DM 15 560 in Germany.

Source: Annual report of SKODA.

A number of former CR trading partners, especially Poland, Hungary and the Slovak Republic, introduced protective measures on the car markets. Export barriers became a barrier to growth. While

import duty on cars in Poland was 35 per cent, SKODA management decided to establish an assembly factory in Poznan in order to overcome high customs tariffs imposed on personal cars in Poland. A contract on the establishment has also been signed with Russia in Smolensk and similar projects are being prepared in India and China.

### ***Tax breaks and the tax system***

The company was exempt from payment of corporate tax during two years. The company did not make any profit during this period of time. Therefore, a tax break could not be used as an incentive. Even if the company made profits, the recent government would most probably be opposed to providing the promised tax breaks.

According to management, it was investment related to the first model-Felicia-and the advance expenditure for the second model range (development expenditure and production facilities) which have burdened the financial statement and led to losses so far.

Additional investment related to the new factory will take place in 1996.

**Table 6. Profitability of SKODA Mlada Boleslav**  
(billion CZK)

	1994	1995
Sales revenue	43.9	31.0
Profit/loss	-2.37	-1.62

*Source:* Annual report of SKODA Auto, 1996.

According to SKODA management, no other incentive related to accounting, such as depreciation of fixed assets, has been realised.

Removal of the turnover tax and introduction of VAT in January 1993, together with a whole new tax system, represented support for SKODA and had a positive result on the performance and exports of the company.

The ability to cover losses from future profit is possible without any limitation, not only for Volkswagen, but for all investors in the Czech Republic.

Corporate tax was gradually reduced from 65 per cent in 1990 to 39 per cent in 1996. It is expected that the corporate tax rate will decrease in the future by another two to seven points.

### ***The banking system and convertibility of currency***

At the time of closing the deal, the Czech currency was not convertible and the government promised that SKODA would receive exemption from its duty to supply free convertible currency to the State Bank. The permit was granted to open a foreign currency account with a foreign bank. By opening accounts with a foreign bank, VW avoided the inefficiency of the local banking system.

The State Bank agreed to provide permission for acquiring credit from foreign banks.

The Foreign Exchange Act changed the situation in the Czech Republic radically by introducing internal convertibility of the Czech currency, which brought free access to foreign currency for businesses and free transfer of profits.

The Czech crown has been fully convertible since 1 October 1995 according to the Foreign Exchange Act N°. 219/1995 Coll, 26 September 1995. The new law complies with Art.8 of the IMF Charter as a pre-requisite for OECD membership. Convertibility applies to all current account and capital account operations.

The exemption provided in 1991 only to SKODA-VW became accessible to all investors and businesses. Volkswagen, in many respects, was a pioneer for the improvement of the business environment and investment conditions.

### ***Telecommunications and re-qualification of the labour force***

The current poor situation in telecommunications is clearly a barrier to business development. Not only is it difficult to acquire new telephone lines, but the old ones do not work properly, and prices for phone services and rates are higher than those in Western Europe.

Skoda used its power to convince Telecom to invest in the telecommunication system in the region where SKODA is located. This is considered to be effective assistance to business.

Cooperation with local authorities is mutually beneficial and local government provide support to SKODA employees and for infrastructure. The local budget benefits about 300 million CZK yearly from contributions to social welfare. There is a 1.2 per cent unemployment rate in the region, well below the national average (about 2.5 per cent).

Labour is in short supply in the Czech Republic, especially in the Mlada Boleslav region. The rate of unemployment and labour mobility are low. There are about 1 500 foreign employees (mainly from Poland and the Slovak Republic) working in the company.

### **Volkswagen's promises and commitments**

During the negotiations with the foreign partner, the following conditions were stated by the Government and VW committed to them at the time of signing of the contract:

1. VW will invest DM 8.2 billion between 1991 and 2000;
2. output will increase by approximately 100 per cent to about 400 000 cars per year;
3. supplies will rely on domestic producers and suppliers in expectation of a “multiplier effect” on these producers;
4. the number of employees will increase;
5. a hall for engine production will be constructed;
6. a new model of engine will be developed;
7. the Skoda trademark will be preserved.

Volkswagen agreed to the above conditions because it prepared a scenario similar to SEAT in Spain. At that time there had not been any bad experiences with VW investing in SEAT.

According to the present situation, and at first glance, none of these conditions have been fully kept:

- planned output of 400 000 cars is only 340 000;
- the number of domestic suppliers, as well as their share in the supply of parts and materials, is continuously decreasing;
- employment has been reduced;
- investment was drastically reduced to DM 3.7 billion;
- the Skoda trademark had to be modified.

It is difficult to say whether it would be better if all the above conditions were fulfilled. For instance, in 1991 it was expected that unemployment would grow and thus maintenance, or creation of new working possibilities, had been an important aspect of the deal for the government. The expectations were not realised and now there is the opposite problem (at least in the region of SKODA): it is hard to find workers, while unemployment is very low.

Similarly, investment has been considered crucial for the economy which had been declining. Meanwhile, the economy started to grow and future investment is not as important.

What is important is the export performance, along with productivity growth and product quality. None of these conditions have been required from Volkswagen. Nevertheless, all have been fulfilled and they are crucial elements in the success story of SKODA.

### ***Investment commitments***

Volkswagen promised to produce a new model of mid-sized car and a complete production program wherein DM 8.2 billion would be invested over a period of ten years. The highest investment commitments played the decisive role in the selection of Volkswagen as a foreign partner.<sup>5</sup>

In December 1993 Volkswagen decreased the pledged sum from DM 8.2 billion to DM 3.7 billion. Volkswagen decided not to build a new plant for engine production. It appears that the investment commitment *has not been guaranteed by penalties in the contract and thus could have been voluntarily fulfilled or not.*

At the last minute, VW did not sign the credit of DM 1.4 billion for capital investment in SKODA-VW, committed by a consortium of 50 world banks and organised by IFC. VW argued that most of the necessary investment was, is and will be financed from cash flows.

Because of the staging of the investment, Volkswagen was able to scale-down its investment. In 1995, up to 50 per cent of the investment had been covered by cash flows.

Another CZK 13.5 billion are planned to be invested in 1996. Actual investment in production and products will come into effect in 1997.

During 1992-1995, Skoda-Volkswagen made phased upgrades in the capital equipment, beginning with the painting area and metal presses. The next stage included an expansion of

production capacity. The strategic plan also involved building a new engine facility, which will be not realised, as engines will be imported from Germany. The plan to introduce new product lines has also been turned down.

Table 7. **Investment and depreciation (1991-1995)**  
(million CZK)

	1991	1992	1993	1994	1995	Total
Investment	1 114	3 766	4 796	7 617	5 613	22 906
Depreciation	709	1 022	3 004	2 713	3 604	11 052

*Source:* Annual report SKODA Auto 1995.

Instead of large investments, VW decided to modernise the existing equipment and upgrade the production capacity from the current 200 000 to 340 000 vehicles per year, introducing at the same time a second, larger model series.

The equipment will be utilised in up to 20 shifts per week within the framework of an annual working time schedule.

Skoda-Volkswagen has built its own distribution network and supported the development of private distributors. It has also negotiated for the direct sale of Skoda cars abroad.

### ***Output***

Productivity is increasing by ten per cent yearly. Salaries, which range from CZK 3 900 to CZK 14 000, according to education and skills, grew by 16 per cent in 1995. Recently, SKODA has been producing almost 14 cars per year per employee. (By comparison, in Wolfsburg 15 cars per year per employee are being produced.)

Table 8. **Output of SKODA cars**  
(1991-1995)

Year	Number of cars
1991	172 074
1992	200 059
1993	219 612
1994	173 566
1995	208 279

*Source:* Association of the automotive industry, 1996.

In 1991 only 25 per cent of production was sold domestically.

After the fall in sales in 1991 -- caused by changes in the business environment, a fall in domestic demand and the overall situation on the world car markets -- production of SKODA Auto started to grow. SKODA is oriented towards export but is also attempting to gain a larger share of the domestic market. There are 2600 SKODA car dealers in 60 countries, 215 in the Czech Republic and 70 in the Slovak Republic.

Skoda-VW has recently produced the Felicia model and is preparing a new model of middle-class car. The production structure is the same as VW's, with quality, price and service being the main determinants of the strategy of the company.

### *Suppliers*

Cooperation with suppliers is changing. The concept of supplier integration has been adopted (also among the first in the VW conglomerate). Suppliers are being integrated with Skoda-VW. Six such integrated suppliers exist.

More than forty joint-ventures have been established in the Czech Republic, which are in some way connected with Skoda-VW. The investors are not only German but also Italian, French, American, and British.

By the end of 1994, Skoda had 279 suppliers, 174 of which were Czech, 19 Slovak and 86 foreign. In terms of the value of supplies, out of CZK 19 600 billion, CZK 14 billion went to Czech suppliers, CZK 3.5 billion to foreign, and CZK 2.1 billion to Slovak in 1994. In 1994 foreign suppliers were securing 17 per cent of the value of total supplies and in 1995 already 21 per cent (Slovak suppliers being considered as "domestic"). In 1995 416 out of 193 suppliers were foreign, 18 Slovak and 205 Czech. The situation in 1995 is depicted by the following table.

Table 9. **Value of purchased materials according to the origin (1995)**  
billion CZK

Suppliers	
Czech Republic	16.1
Slovak Republic	2.1
Foreign	4.9
Total	23.1

*Source:* Annual report SKODA Auto 1995.

### *Employment*

In preparation of its offer, the management of Volkswagen promised continued and good employment conditions to the workers and published a statement of social policy. In turn, this created pressure from both the public and from Skoda workers and management to accept the Skoda offer.

Skoda-VW has about 15 500 employees, of which 13 900 are in the Mlada Boleslav plant, 900 in Vrchlabi and 1 200 in the Kvasiny production facility. The number of employees has been decreasing since 1991 and is expected to be maintained at the existing level.

**Table 10. Number and educational structure of employees**

Number of employees	1991	1995
	5 224	2 410
Basic education		
Skilled workers	7 401	7 819
Secondary school	3 652	4 208
University education	706	1 212
<b>Total</b>	<b>16 983</b>	<b>15 649</b>

*Source:* Annual report of SKODA Auto 1995.

Concise educational system at Skoda-VW consists of:

- building a corporate culture and communication network;
- all employees are taking part in a training programme (5.8 days in average);
- about 1 000 apprentices are trained in 19 professions;
- 244 language courses, more than 2 000 participants.

Skoda-VW spent CZK 151 million on employee training in 1994.

The average salary for SKODA-VW is CZK 11 400 (excluding the salaries of German managers), which is well above the country's average.

Due to expectations of high unemployment, the government provided relatively high subsidies from the state budget for re-qualification and unemployment benefits. These funds have been distributed on a regional basis.

While unemployment remains at a modest level, the funds are not used or generally available for viable projects. This is a common situation, which might have been used by VW, like any other company or entrepreneur.

### **Amendment of the contract and conclusions**

Since the establishment of the SKODA-VW joint-venture, the Government changed, and so did the attitude towards FDI incentives. Legislation and taxation changed radically.

Because of the revision of its investment plans and the announced plan for the total restructuring of VW in 1993, the Czech government also re-considered its plans and commitments to VW with

regard to the further buy-out of the shares by VW. The Czech government started to negotiate an amendment to the contract SKODA-VW at the end of 1993.

As a result, the following issues were agreed upon in the amendment signed in 1995:

- SKODA Auto will optimise the investment programme. SKODA Auto will invest so that the installed capacity will reach a minimum of 340 000 cars;
- the government will provide support to the Czech automobile industry while maintaining competition;
- the Czech government has a right of veto in the general assembly decisions despite its minority shareholder stake (protection of minority shareholder rights).

No concrete measures or *bound* numbers have been agreed and no penalties have been considered. As for the fulfilment of future investment commitment, a good bargaining position of the government is created by the possibility to influence the recent and future protection of the car market.

Volkswagen invested in 1991, when the political as well as the economic situation was not stable. The importance of foreign investment by such an important company was, at that time, a sign of trust in the future development and prosperity of the country.

In 1996 the political and economic situation is relatively stable, most of the exemptions which VW required have become a general rule thanks to the convertibility of the currency and the improvement in the banking system. Telecommunications are expected to improve, with a large foreign investment in TELECOM at the end of last year.

Today, it is not important whether the commitments and allowances have been fulfilled, be it for objective or subjective reasons. It was a precedent for other investors and a signal to the world that the Czech Republic (or former Czechoslovakia) was a good region for investment. The SKODA car factory has been saved from big problems *and though it is not displayed in the profit account*, the incentives provided or promised at that time have fulfilled their role.

With a turnover of CZK 44 billion in 1995, SKODA Auto is the second largest Czech industrial company in the Czech Republic. In 1995 Skoda-VW provided, directly and indirectly (in the supplier industry), employment to about three per cent of the labour force of the CR and its share in total Czech exports was five per cent; in 1996 it was almost seven per cent. SKODA Auto radically increased the quality of their cars. Demand for the Felicia model is growing as customers appreciate good price-to-value ratio. Skoda Auto succeeded in opening up new markets world-wide. A new middle-class model will be introduced in 1996.

The present financial situation is good. VW introduced standard management practices and built an efficient distribution network. Since October 1995, the company has consistently broken even in the monthly results.

Thus, SKODA-VW can be evaluated as a successful deal from which both sides benefited: the Czech state and the VW Group, of which SKODA is the youngest of four autonomous brands.<sup>6</sup>

## Notes

1. This study represents a continuation of a case study on Skoda Volkswagen that was completed in 1992 (“Methods of Privatising Large Enterprises”, OECD, CCET 1993). The author revisited the firm and representatives of state authorities in May 1996 to assess developments to date.
2. The valuation was based on a discounted cash flow model of the company, assuming no dividends early in the project; retention of funds for investment; tax-loss carry forwards; a maximum profit tax of 40 percent; and gradually increasing labour costs.
3. N° 63/1991 Coll. of Law, Article 9.
4. Foreign investors are usually accused to contribute to the environmental damages: SKODA is the opposite case while following its own interest it contributes to the improvement of the environment. SKODA lobbied in the government to issue a decree on curbing import of second hand cars: the cars imported are not allowed to be older than five years and have to possess catalyser.

The law which regulates import of second hand cars was issued in 1994 and as a consequence number of imported cars decreased but still second hand cars have the major part of the market.

5. Second most serious potential strategic partner, Renault, offered investments of DM 3.9 billion to produce a mini-car and a new Renault 19.
6. VW Group reached net profit DM 336 million in 1995 and sold 3568000 cars world wide, what means growth by 0.3 per cent (turnover DM 88.12 billion). SKODA increased its sales by 15 per cent and output by 20 per cent, thus producing about six per cent from the number of cars produced by VW Group.



*Appendix*

**Table 1. Import penetration, export performance and customs protection  
by selected manufacturing groups of products  
(1992 and 1994)**

	Import penetration *		Export performance **		Customs tariff ***	
	1992	1994	1992	1994	Base	Bound
Foodstuffs and tobacco	14.3	19.2	8.2	8.9	19.3	14.1
Textile	5.6	12.0	35.3	44.6	7.2	5.5
Chemicals	44.8	61.0	27.7	40.9	5.0	3.6
Rubber and plastics	34.0	49.3	24.9	32.5	5.5	4.4
Metals	15.8	34.8	31.7	45.4	5.7	4.6
Machinery	43.8	52.5	21.2	35.6	5.8	4.7
Automotive	30.3	42.4	36.7	42.7	9.3	7.9
Ceramics, glass, stone	12.7	24.4	35.3	38.8	8.7	6.6
Furniture	42.4	47.5	42.8	44.7	6.2	4.6
Instruments	69.8	73.3	28.6	44.9	3.9	2.9
Paper and pulp	28.1	41.1	26.8	33.5	6.0	4.7
Wooden products	11.7	23.2	30.6	42.4	4.8	3.6

\* import penetration = value of total imports of the group of products divided by the value of domestic sales of domestic manufactures minus their exports plus imports.

\*\* shares of exports on the total sales.

\*\*\* computations have been done as averages based on imports for 1993.

Source: Czech Statistical Office data on individual manufacturing enterprises, custom tariffs statistics adjusted for TOBACCO classification, own computations ( \* and \*\*), CVEV(\*\*\*).



*Annex 1*

**PROGRAMME**

**Advisory Group on Investment**  
**“Incentive Policies For Foreign Direct Investment In Transition Economies”**  
(3-4 June 1996) Bled, Slovenia

Monday, 3 June

**10:00 Introductory Remarks**

*Ms. V. Ravbar*  
*State Secretary*  
*Ministry of Economic Relations*  
*and Development*  
*Slovenia*

*Mr. J-P. Tuveri*  
*Deputy Director*  
*Centre for Co-operation with*  
*the Economies in Transition (CCET)*  
*OECD*

**10:30 Session I:**

**Investment Incentives, Costs, Benefits and Implications for Policy**

**Chairman:**

*Mr. J-P Tuveri*  
*Deputy Director of the CCET*  
*OECD*

**Presentation:**

*Mr. R. Jungnickel*  
*Head of Research Group*  
*HWWA Institute*  
*Hamburg*

**Panel Discussion:**

*Mr. M. Foley*  
*Consultant*  
*Irish Development Agency*  
*Dublin*

*Mrs. A. Zemplinerova  
Center for Economic Research and  
Graduate Education  
Charles University  
Prague*

*Mr. C. Kovacs  
Director  
Barclays de Zoette Wedd Ltd.  
Budapest*

*Mr. D. Holland  
Principal Administrator  
Fiscal Affairs Division  
OECD*

**15:00 Session II:**

**Incentive Policies in Selected Transition Economies**

**Chairman:**

*Dr. M. Schekulin  
Director  
Austrian Ministry of Economic Affairs  
Vienna*

**Presentation I:**

**Slovenia**

*Ms. C. Selsek  
Deputy Managing Director and  
Chief Executive International  
SKB Banka  
Ljubljana*

**Presentation II:**

**Russian Federation**

*Mr. V. Ananiev  
Senior Counsellor  
Ministry of Foreign Affairs  
Moscow*

**Presentation III:**

**Bulgaria**

*Mrs. J. Varga  
Consultant  
Price Waterhouse  
Sofia*

**Panel Discussion:**

*Mr. C. Bachurov  
Vice President  
Bulgarian Foreign Investment Agency  
Sofia*

*Mr. W. Riger  
Director/Croatia  
Raiffeisen Investment AG  
Vienna*

*Mr. M. Kovac  
Director  
Trade and Investment Promotion Office  
Ministry for Economic Relations and  
Development  
Ljubljana*

**18:00**

*Members of the Negotiating Group and the OECD Secretariat will provide a briefing on the  
Multilateral Agreement on Investment (MAI) negotiations to participants.*

**19:30**

*Reception Hosted by the Slovenian Ministry of Economic  
Relations and Development*

**Tuesday, 4 June**

**Session III: Working Groups - Company Case Studies**

**10:00 Working Group I:**

**Financial Incentives**

**Chairman:**

*Mr. M. Cerar  
General Manager  
Belinka Chemical Industry  
Ljubljana*

**Case Study I:**

**Investment in the Ukraine**

*Mr. D. Serdyuk  
Attorney  
B.C. Toms & Co.  
Kiev*

*Mr. I. Podolev  
First Deputy Minister  
Ministry of Foreign Economic Relations  
and Trade  
Ukraine*

**Case Study II:**

**FM Forte in Poland**

*Mr. A. Dorosz  
Deputy President  
Bank Polska Kasa Opieki S.A.  
Warsaw*

*Dr. K. Hughes  
Head of the European Programme  
Royal Institute of International Affairs  
London*

**10:00 Working Group II:**

**Non-Financial Incentives**

**Chairman:**

*Mr. F. Bonciu  
Managing Director  
Romanian Development Agency  
Bucharest*

**Case Study I:**

**British American Tobacco (BAT) in Uzbekistan**

*Mr. K. Silver  
Consultant  
New York*

*Dr. F. Maksudov  
Director General  
Foreign Investment Agency  
Tashkent*

**Case Study II:**

**VW-Skoda in the Czech Republic**

*Mrs. A. Zemplerova  
Center for Economic Research and  
Graduate Education  
Charles University  
Prague*

*Mr. J.A. Havelka  
General Manager  
Czech Agency for Foreign Investment  
CZECHINVEST  
Prague*

**15:00 Closing Plenary:**

**Conclusions and Future Work**

**Chairman:**

*Mr. R. Alter  
Principal Administrator  
Directorate for Financial, Fiscal and  
Enterprise Affairs  
OECD*

**Panel:**

*Dr. M. Schekulin*  
*Director*  
*Austrian Ministry of Economic Affairs*  
*Vienna*

*Mr. F. Bonciu*  
*Managing Director*  
*Romanian Development Agency*  
*Bucharest*

*Mr. M. Cerar*  
*General Manager*  
*Belinka Chemical Industry*  
*Ljubljana*

## **Notes**

### **Opening Plenary**

This session will examine the costs, benefits and policy implications of incentives designed to attract FDI in OECD Member countries and transition economies. A lead presentation will analyse the policy issues related to investment incentives in general. A panel discussion will follow in which the FDI incentives offered by OECD Member countries and by transition economies will be examined and evaluated. The Secretariat will prepare an issues paper to direct the discussion.

### **Session II**

This session will examine the investment policies and incentives offered in three transition economies in order to assess the effectiveness of specific incentives in attracting foreign investment. Investment experts from transition economies will analyse the specific FDI incentives in place. Their presentations will be followed by a panel discussion, which will include the views of the private sector, local foreign investment agencies and of a foreign investment agency of an OECD Member country.

### **Session III**

#### ***Working Group I***

Most incentives schemes involve a purely financial benefit to the investor. Two case studies, one involving an investment in Ukraine and the other an investment in Poland, will be the starting point of a discussion focusing on the effectiveness of financial incentives for a particular project. The participants will assess the costs and the benefits of providing financial incentives.

#### ***Working Group II***

Foreign investors may be attracted by non-financial incentives as well. Two case studies, one involving an investment in Uzbekistan and the other in the Czech Republic, will identify the schemes involved in these particular projects. The participants will evaluate their effectiveness and assess the costs and benefits of non-financial incentives.

### **Closing Plenary**

The outcome of the three sessions will be summarised by the Chairmen, policy recommendations will be made, and future work will be discussed.

*Annex 2*

**LIST OF PARTICIPANTS**

**NIS AND CEEC PARTICIPANTS**

***ALBANIA***

Mr. A. Cico  
Head of Public Investment Unit  
Council of Ministers  
Department of Economic Development and Foreign Aid Coordination  
Tirana, Albania

Phone: 355 42 226 55  
Fax: 355 42 283 62

Mr. S. Xhepa  
Chairman  
Albanian Center for Foreign Investment Promotion  
Blvd. Zhan D'Ark  
Tirana, Albania

Phone: 355 42 301 33  
Fax: 355 42 284 284 39

***ARMENIA***

Mr. A. Salnazarian  
Head - Inspection of Regulation & Supervision  
Ministry of Finance  
Security Market Department  
Melik Adamian 1  
Yerevan  
Republic of Armenia 375010

Phone: 374 2 52 62 21  
Fax: 374 2 15 11 54

***BELARUS***

Mr. I. Belchik  
Chief Specialist  
Ministry of Foreign Trade  
Economic Relations  
Department of Foreign Trade Economy  
29 Myasnikova Street  
Minsk, 220050  
Belarus

Phone: 375 172 20 86 23  
Fax: 375 172 27 39 24

Mr. A. Guryanov  
Deputy Chief  
Credit and Investment Department  
Ministry of Foreign Economic Relations  
29 Myasnkova Street  
Minsk 220050 Belarus

Phone: 375 172 20 85 52  
Fax: 375 172 27 39 24

***BULGARIA***

Mr. C. Bachurov  
Vice President  
Bulgarian Foreign Investment Agency  
3 St. Sofia Street  
1000 Sofia, Bulgaria

Phone: 359 2 980 09 24  
Fax: 359 2 980 13 20

Mr. I. Simeonov  
Expert  
Ministry of Finance  
102 Rakovska Street  
Sofia, Bulgaria

Phone: 359 2 801 148  
Fax: 359 2 872 350

***CROATIA (REPUBLIC OF)***

Mr. B. Baricevic  
Head of Department for Foreign Aid  
Ministry of Foreign Affairs  
Trg N.S. Zrinskog 7-8  
10000 Zagreb

Phone: 385 1 45 69 977  
Fax: 385 1 42 75 94

Dr. V. Kalogjera  
Executive Director  
Croatian Investment Promotion Agency  
Ministry of Economy  
Ul. grada Vukovara 78  
10000 Zagreb

Phone: 385 1 51 95 10  
Fax: 385 1 61 14 210

***ESTONIA***

Ms. P. Karmo  
Project Manager  
Estonian Investment Agency  
6-6028 Ravala Avenue  
EEO 105 Tallinn  
Estonia

Phone: 372 6 410 166  
Fax: 372 6 410 312

***FYROM***

Ms. M. Petrovksa  
Ministry of Foreign Affairs  
Dame Gruev 4 - Skopje

Phone: 389 91 22 25 43

Fax: 389 91 22 33 27

Mrs. D. Zafirovska  
Head of Department  
Ministry of Foreign Affairs  
"Dame Gruev" 4 - Skopje

Phone: 389 91 110 333

Fax: 389 91 115 790

***KAZAKHSTAN***

Mr. A. Ilevov  
Deputy Head of Department  
Ministry of Economy  
Zheltoksan Str. 115  
Almaty, Kazakhstan

Phone: 7 3272 629 532

Fax: 7 3272 62 2770

Mr. V. Syschikov  
Deputy Chairman  
Committee for Utilisation of Foreign Capital  
Alban Khan av 93  
Almaty  
Kazakhstan

Phone: 7 3272 62 43 11

Fax: 7 3272 62 27 70

***LATVIA***

Ms. I. Graudina  
Advisor to the State Minister of Investment  
and Credit Policy  
Ministry of Finance  
Smilsu Iela 1,  
Riga, LV-1919  
Republic of Latvia

Phone 371 722 97 50

Fax: 371 882 00 10

Mr. E. Kizenbach  
Head  
Latvian Development Agency  
Investment Projects Department  
2 Perses St.  
Riga, LV-1442, Latvia

Phone: 371 7283425

Fax: 371 7282524

## ***LITHUANIA***

Mr. B. Sinnerton  
Advisor  
Lithuanian Investment Agency  
Sv. Jono 3  
2600 Vilnius, Lithuania

Phone: 370 2 62 38 70  
Fax: 370 2 22 01 60

## ***MOLDOVA***

Mr. I. Caraganciu  
Vice Director  
Foreign Investment Promotion Agency  
Ministry of Economy  
Piata Marii Adunari Nationale 1, 301  
Chisinau, Moldova MD033

Phone: 373 2 23 40 54  
Fax: 373 2 23 40 46

Mr. G. Gaberi  
Director  
Foreign Investment Promotion Agency  
Ministry of Finance  
Piata Marri Adunari nationale 1  
301 Chisinau  
Moldova

Phone: 373 2 23 36 56  
Fax: 373 2 23 40 46

## ***MONGOLIA***

Mr. B. Chimgee  
Senior Officer  
Ministry of Industry and Trade  
Department of Industry and Foreign Investment  
Chingeltei district UB - 11  
6th Horoolol 2 A  
3-33, Ulaanbator

Phone: 976 326 040  
Fax: 976 1 326 325

Mr. C. Duujii  
Counselor, Policy Coordination Department  
Ministry of External Relations  
Chingeltei District  
POB 46/994  
Ulaanbator, Mongolia

Phone: 976 1 323 987  
Fax: 976 1 326 849

## ***POLAND***

Mr. A. Kaczmarek  
Vice President  
PAIZ - Polish Agency for Foreign Investment  
Al Roz 2  
00-559 Warsaw, Poland

Phone: 48 22 621 06 23  
Fax: 48 22 621 84 27

Ms. A. Sawaszkiewicz  
Chief Expert - Investment Policy Division  
Ministry of Finance  
State Treasury Bureau  
ul. swietokrzyska 12  
00-916 Warsaw, Poland

Phone: (48 22) 694 36 44

Fax: (48-22) 694 45 52

Mr. S. Zalboka  
Chief of System Transformation Division  
Ministry of Finance  
State Treasury Department  
Swietokrzyska 12  
00-916  
Warsaw, Poland

Phone: (48-22) 694 31 09

Fax: (49-22) 694 4552

### ***ROMANIA***

Mr. F. Bonciu  
Director General (Strategy & Promotion)  
Romanian Development Agency  
7 Bagheru Blvd.  
Bucharest  
Romania

Phone: 401 312 14 32

Fax: 401 312 03 71

Ms. G. Vladescu  
Researcher  
Romanian Development Agency  
7 Magheru Blvd  
Bucharest, Romania

Phone: 401 615 46 98

Fax: 401 613 24 15

### ***RUSSIAN FEDERATION***

Mr. V. Ananiev  
Senior Counsellor  
Ministry of Foreign Affairs  
Moscow, Smolenskaya Sennaya, 32/34  
Russian Federation

Phone: 7 095 241 22 15

Fax: 7 095 253 90 88

### ***SLOVAK REPUBLIC***

Mr. A. Kozma  
Chief of Division  
Foreign Financial Relations Department  
Ministry of Finance  
Stefanovicova 5  
813 08 Bratislava  
Slovak Republic

Phone: 42 7 357 2337

Fax: 42 7 491 125

Ms. K. Kovacova  
Officer  
Ministry of Finance  
Foreign Financial Relations Department  
Stefanovicova 5  
813 08 Bratislava  
Slovakia

Phone: 42 7 357 23 08

Fax: 42 7 491 125

***SLOVENIA***

Mr. M. Gaspari  
Minister  
Ministry of Finance

Mr. M. Dragonja  
Minister  
Ministry of Economic Affairs

Mr. J. Dezelak  
Minister  
Ministry of Economic Relations and  
Development

Mr. T. Rop  
Minister  
Ministry of Labour, Family and Social Affairs

Ms. V. Ravbar  
State Secretary  
Ministry of Economic Relations and  
Development

Mr. J. Drogenik  
State Undersecretary  
Ministry of Economic Relations and Development

Mr. M. Kovac  
Director  
Trade and Investment Promotion Office  
Ministry of Economic Relations and  
Development

Mr. J. Potocnik  
Director  
Institute of Macroeconomic Analysis and  
Development

Mr. V. Dimovski  
Industry State Secretary  
Ministry of Economic Affairs

Mr. J. Cuk  
President  
Chamber of Economy of Slovenia

Mr. C. Stantic  
Vice President  
Ministry of Economic Relations and Development

Ms. M. Puc  
Director  
Agency for Reconstruction and privatisation

Mr. V. Nemc  
Director  
Development Fund of the Republic of Slovenia

Mr. B. Lukman  
Director  
Office for European Affairs

Mr. I. Rejc  
Chairman  
Parliament Committee for Privatisation

Mr. J. Kopac  
Chairman  
Parliament Committee for Finance

Mr. F. Horvat  
Chairman  
Parliament Committee for Economy

Mr. F. Stiblar  
Economic Institute of Law

Mr. J. Repines  
Counsellor to the Government  
Ministry of Economic Affairs  
Kotnikova 5  
1000 Ljubljana  
Slovenia

Phone: 386 61 178 32 95

Fax: 386 61 133 12 20

Dr. M. Rojec  
Senior Research Fellow  
Faculty of Social Sciences  
University of Ljubljana  
Kardeljeva Pl 5  
PO Box 2547  
S1-1000 Ljubljana, Slovenia

Phone: 386 61 1682 174

Fax: 386 61 1682 329

Prof. M. Svetlicic  
Professor of International Economics  
Faculty of Social Sciences  
University of Ljubljana  
Kardeljeva Pl 5, PO Box 2547  
S1-1000 Ljubljana, Slovenia

Phone: 386 61 168 14 61

Fax: 386 61 1682 329

Mr. Matt Connolly  
Advisor  
The Republic of Slovenia  
Ministry of Economic Relations and  
Development  
Trade and Investment Promotion Office

Phone: 386 61 178 3557  
Fax: 386 61 178 35 99

***UKRAINE***

Mr. G. Mozer  
Head  
Supreme Rada of the Ukraine  
Subcommittee on Foreign Investments &  
Joint Ventures  
3 Sadova Str, Kiev 19  
Ukraine

Phone: 38 044 291 74 51  
Fax: 38 044 293 38 30

Mr. I. Podolev  
First Deputy Minister  
Ministry of Foreign Economic Relations  
8 Lvivska Sq.  
GSP 655  
254655, Kiev 53, Ukraine

Phone: 38044 226 33 78  
Fax: 38044 226 21 12

***UZBEKISTAN***

Ms. M. Kotikova  
General Manager, Political Risks Insurance  
Department  
Uzbekinvest (National Insurance Company  
of the Republic of Uzbekistan  
49 Suleimanova Street  
Tashkent 700017  
Republic of Uzbekistan

Phone: 7 3712 33 05 56  
Fax: 7 3712 33 07 04

Mr. F. Maksudov  
President  
Foreign Investment Agency  
16 a Navoiy Str.  
Tashkent, Uzbekistan  
700011 Uzbekistan

Phone: 7 3712 41 55 41  
Fax: 7 3712 89 12 01

## **OECD MEMBER COUNTRIES**

### **AUSTRIA**

Mr. M. Bischof  
Coordinator - Financing Guarantee Association  
FGG/East-West Fund  
A-1040 Vienna  
Prinz-Eugen-Strabe 8  
1041 Vienna, Austria

Phone: 43 1 501 75 375  
Fax: 43 1 501 75 360

Mr. H. Hutterer  
Managing Director  
Financing Guarantee Association  
EGG/East-West Fund  
Prinz-Eugen - Strasse 8  
1041 Wien  
Austria

Phone: 43 1 501 75 302  
Fax: 43 1 501 75 360

Ms. M. Pacher  
General Director  
International Co-operation and Development  
Vienna  
Austria

Phone: 43 1 588 58 23  
Fax: 43 1 586 86 59

Ms. A. Subic  
Local Representative (Slovenia)  
FGG/East-West Fund  
Kuzmiceva 5  
61 000 Laibach  
Slovenia

Phone: 386 61 32 89 23  
Fax: 386 61 328 923

Mr. M. Schekulin  
Director  
Ministry of Economic Affairs  
Stubenring 1  
A-1010 Vienna  
Austria

Phone: 43 1 71 100 X 5180  
Fax: 43 1 714 27 22

### **CZECH REPUBLIC**

Ms. J. Cikkova  
Journalist  
HOSPODARSKE NOVINY  
NA Florennci 19  
11000 Prague 1  
Czech Republic

Phone: 42 2 282 23 90  
Fax: 42 2 232 7236

Mr. J.A. Havelka  
General Manager  
CZECHINVEST  
Czech Agency for Foreign Investment  
Politických Veznu 20  
112 49 Prague 1  
Czech Republic

Phone: (42) 2 2422 15 40

Fax: (42) 2 2422 18 04

### ***FINLAND***

Mr. P. Valtonen  
Industrial Counsellor  
Ministry of Trade and Industry  
Industry Department  
Aleksi 4  
FIN-00170 Helsinki  
Finland

Phone: 358 0 160 3614

Fax: 358 0 160 2694

Ms. K. Vartiainen  
Senior Financial Advisor  
Ministry of Finance  
PO Box 286  
FIN-00171 Helsinki  
Finland

Fax: 358 0 160 4755

### ***FRANCE***

M. Claude Warnet  
Conseiller Financier  
French Delegation to the OECD  
21 rue Octave Feuillet  
75116 Paris

Phone: (33-1) 45 24 97 69

Fax: (33-1) 45 24 15 89

### ***GERMANY***

Ms. M. Maes-Baier  
Deputy Head of Division  
Federal Ministry of Economics  
Villemombler Strasse 76  
53123 Bonn  
Germany

Phone: 49 228 615 35 16

Fax: 49 228 615 26 87

### ***GREECE***

Ms. C. Magiati  
Specialist on Incentive Policy &  
Legislation  
Ministry of National Economy  
5-7 Nikis Str.  
Athens, 10180 Greece

Phone: 301 333 22 54

Fax: 301 333 23 26

Mr. D. Poulakis  
Specialist on Incentive Policy and  
Legislation  
Ministry of National Economy  
5-7 Nikis Street  
Athens - 10180  
Greece

Phone: 301 333 22 54

Fax: 301 333 23 26

### ***HUNGARY***

Mr. B. Kovacs  
Advisor  
National Bank of Hungary  
H-1850 Budapest V.  
Szabadsag ter 8/9  
Hungary

Phone: 36 1 302 3000

Fax: 36 1 269 17 60

Mrs. Suzan Szucs  
Director  
Ministry of Industry and Trade  
Budapest Honved u 13-15  
Budapest  
Hungary

Phone: 36 1 118 4540

Fax: 36 1 118 53 68

Dr. C. Ungvári  
Director  
Hungarian Investment and Trade Development  
Agency  
H-1051 Budapest V. Dorottya U. 4  
H-1364 Budapest, PO Box 222  
Hungary

Phone: 36 1 118 49 48

Fax: 36 1 118 37 32

### ***ITALY***

Mr. A. Pollano  
Director  
Italian Trade Commission  
Istituto Commercio Estero  
c/o Italian Embassy  
Ljubljana, Slovenia

Phone: 386 61 125 43 16

Fax: 386 61 125 43 16

### ***JAPAN***

Mr. F. Sugiura  
Technical Assistant  
Japanese Delegation to the OECD  
11 avenue Hoche  
75008 Paris  
France

Phone: (33-1) 53 76 61 84

Fax: (33-1) 45 63 05 44

***THE NETHERLANDS***

Mr. P. van der Linde  
International Investment Division  
Ministry of Economic Affairs  
Foreign Economic Relations  
PO Box 20101  
2500 EC's-Gravenhage  
Pays-Bas

Phone: 31 70 379 75 97

Fax: 31-70 379 79 24

***SPAIN***

Mr. V. Saval  
Economic Counselor  
Spanish Embassy in Austria & Slovenia  
Stubenring 16 PO Box 604  
Austria

Phone: 43 1 513 3933

Fax: 43 1 513 81 47

***TURKEY***

Mrs. A. Olçer  
Regional Co-ordinator  
DEIK (Foreign Economic Relations Board)  
Istiklal Caddesi 286/9 Beyoglu  
80050 Istanbul  
Turkey

Phone: (90-212) 243 41 80

Fax: (90-212) 243 41 84

***UNITED KINGDOM***

Mr. N. Banasevic  
Economist  
Department of Trade and Industry  
Room 318 Kingsgate House  
66-74 Victoria Street  
London SW1E 6SW  
United Kingdom

Phone: 44 171 215 4541

Fax: 44 171 215 45 20

***UNITED STATES***

Mr. M. Kavcic  
Economic and Commercial Assistant  
American Embassy Ljubljana  
Praekova 4,  
1000 Ljubljana  
Slovenia

Phone: 386 61 301 427

Fax: 386 61 301 401

**EEC**

Mr. C. Costopoulos  
Principal Administrator  
European Commission  
rue d'Arlon 88  
1040 Brussels  
Belgium

Phone: 32 2 299 0228

Fax: 322 299 06 02

**PRIVATE SECTOR/BIAC**

Ms. S. Bially  
Administrator  
Business and Industry Advisory Committee to  
the OECD  
13-15 Chaussée de la Muette  
75016 Paris

Phone: (33-1) 42 30 09 60

Fax: (33-1) 42 88 78 38

Mr. M. Bouchal  
Advisor to the Vice President  
Komerční Banka  
NA Pirkope 33  
114 07 Prague 1  
Czech Republic

Phone: 42 2 24 02 20 98

Fax: 42 2 24 24 30 33

Mr. M. Cerar  
General Manager  
Belinka Chemical Industry  
PO Box 4973  
1001 Ljubljana  
Slovenia

Phone: 386 61 188 6200

Fax: 386 61 371 695

Mr. C. Kovacs  
Director  
Barclays de Zotte Wedd Ltd.  
East West Business Centre  
1st Floor Rakoczi ut 1-3  
H-1088 Budapest  
Hungary

Phone: (36) 1 266 0230

Fax: (36) 1 266 0342

Mr. W. Riger  
Director, Croatia  
Raiffeisen Investment AG  
Aspernbruckengasse 2  
A-1020 Vienna  
Austria

Phone: (43-1) 213 19 23

Fax: (43-1) 213 19 17

Ms. C. Selsek  
Executive Director  
SKB Banka, D.D.  
Ajdovscina 4  
61000 Ljubljana  
Slovenia

Phone: 386 61 302 027

Fax: 386 61 302 808

## **TUAC**

Mr. R. Jones  
Assistant to the Secretary-General  
TUAC  
26 avenue de la grande-armée  
75017 Paris, France

Phone: (33-1) 47 63 42 63

Fax: (33-1) 47 54 98 28

## **PRIVATE SECTOR**

### ***B.C. TOMS & CO.***

Mr. D. Serdyuk  
Attorney  
B.C. TOMS & CO.  
18 Proreznaya St.  
Apt. 1 Kiev  
252037  
Ukraine

Phone: 38044 228 1000

Fax: 38044 228 75 08

Mr. Bate C. Toms  
Senior Partner  
B.C. Toms & Co.  
Law Offices  
64 London Wall  
London, EC2M 5TP  
United Kingdom

Phone: 44 171 638 7711

Fax: 44 171 382 9360

### ***BANK POLSKA KASA OPIEKI***

Mr. A. Dorosz  
First Deputy President  
Bank Polska Kasa Opieki S.A.  
Grzybowska Street 53/57  
00-950 Warsaw, Poland

Phone: 48 2 656 02 23

Fax: 48 2 656 04 43

### ***DELOITTE & TOUCHE***

Ms. M. Nosan  
Director - Management Consulting  
Deloitte & Touche  
Dunajska 22  
6100 Ljubljana  
Slovenia

Phone: 386 61 131 8111

Fax: 386 61 131 63 23

Ms. A. Podbevsek  
Director/Partner  
Deloitte & Touche  
Dunajska 22  
1000 Ljubljana  
Slovenia

Phone: 386 61 131 8111

Fax: 386 61 131 62 32

***PRICE WATERHOUSE***

Ms. J. Varga  
Senior Tax Manager  
Price Waterhouse  
10 Stephan Kardia Street  
1000 Sofia, Bulgaria

Phone: 359 2 88 01 22

Fax: 359 2 87 24 61

**EXPERTS**

***CERGE EI***

Dr. A. Zemplerova  
Economic Institute of the Academy of  
Sciences  
PO Box 882  
Politckych veznu 7  
111 21 Prague - Czech Republic

Phone: 42 2 24 005 136

Fax: 42 2 24 211 374

***HWWA***

Mr. R. Jungnickel  
Head of Research Group  
HWWA Institute for Economic Research  
Neuer Jungfernstieg 21  
D-20 347 Hamburg  
Germany

Phone: 49-40-35-62-411

Fax: 49 40 35 19 00

***IRISH DEVELOPMENT AGENCY***

Mr. Michael Foley  
Projects Director  
Irish Development Agency  
13 Kilgobbin Heights  
Sandyford Dublin 18  
Ireland

Phone: (353) 1 660 9133

Fax: (353) 1 295 87 30

***ROYAL INSTITUTE***

Dr. K. Hughes  
Head, European Programme  
The Royal Institute of International Affairs  
Chatham House  
10 St. James's Square  
London Sw1Y 4LE  
United Kingdom

Phone: 44 171 957 57 00

Fax: 44 171 957 57 10

***INDEPENDENT CONSULTANT***

Mr. K. Silver  
Consultant  
135 Fifth Avenue #6D  
Pelham, NY 10803

Phone: 914 738 89 62

**MULTILATERAL AGENCIES**

***EBRD***

Ms. V. Glasmacher  
Economist  
European Bank for Reconstruction and  
Development (EBRD)  
One Exchange Square  
London EC2A 2EH  
United Kingdom

Phone: 44 1 171 338 78 36

Fax: 44 1 171 338 61 10

***UNECE***

Mr. G. Hamilton  
Economic Affairs Officer  
United Nations Economic Commission for  
Europe  
Palais des Nations OFFICE 433  
CH- 1211 Geneva 10  
Switzerland

Phone: 41 22 917 28 38

Fax: 41 22 917 0037

***WORLD BANK***

Mr. G. El-Rifai  
Director  
World Bank  
(Resource Mobilization & Private Sector  
Development)  
1818 H Street, N.W. Room H-6111  
Washington, D.C. 20433  
U.S.A.

Phone: 1 202 473 6162

Fax: 1 202 522 0006

**OECD Secretariat**

***CCET***

Mr. J. P. Tuveri  
Deputy Director  
Centre for Co-operation with the  
Economies in Transition (CCET)  
2 rue André Pascal  
75016 Paris

Phone: (33-1) 45 24 87 38

Fax: (33-1) 45 24 91 77

Mr. A. Rottier  
Principal Administrator  
Centre for Co-operation with the  
Economies in Transition (CCET)

Phone: (33-1) 45 24 13 96

Fax: (33-1) 45 24 91 77

***DAFFE***

Mr. R. Ley  
Head  
International Investment and Services  
Division  
Directorate for Financial, Fiscal and  
Enterprise Affairs  
OECD

Phone: (33-1) 45 24 91 19

Fax: (33-1) 45 24 78 52

Mr. R. Alter  
Principal Administrator  
Directorate for Financial, Fiscal and  
Enterprise Affairs  
OECD

Phone: (33-1) 45 24 16 42

Fax: (33-1) 45 24 78 52

Mr. D. Holland  
Principal Administrator  
Fiscal Affairs Division  
Directorate for Financial, Fiscal and  
Enterprise Affairs  
OECD

Phone: (33-1) 45 24 97 26

Fax: (33-1) 45 24 97 26

Ms. B. Peitsch  
Administrator  
Directorate for Financial, Fiscal and  
Enterprise Affairs  
OECD

Phone: (33-1) 45 24 1877

Fax: (33-1) 45 24 78 52

Mr. A. Kalmanovitz  
Consultant  
Directorate for Financial, Fiscal and  
Enterprise Affairs

Phone: (33-1) 45-24-1989