The Efficiency of Tax Expenditures in boosting Economic Growth – a comparative analysis

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OBJECTIVES

- Incentives for FDI in trasitional countries
- Similarities and differences in tax incentives in Croatia and Serbia
- Implications on the economic growth

RESEARCH HYPOTHESES

- **General hypothesis:**

➢ The effectiveness of tax incentives, in combination with other non-tax incentives, lead to an increase in FDI inflows which is followed by an acceleration of economic growth in host countries

Do fiscal incentives have a role in attracting FDI?

- UNCTAD (WIR, 2015,p.208): Redundancy of many schemes for attracting FDI, as they are often inefficient and ineffective, still used worldwide

- **However,** almost all the arguments against the use of incentives are based on the way incentives are granted or administered, **not on *incentives per se***

- Tax incentives are one of the **few available tools** that can help overcome specific disadvantages + also steer investment into priority areas

- **Key to maximizing the strategic value** of incentives → priority activities for development and on underdeveloped regions, and associating them with sustainable development impacts

- These may include **economic impacts**, such as employment generation, training and capacity building, and technology and know-how transfer; social impacts, such as better availability and accessibility of services, ...

Do taxes matter?

- **Tax factors are not the most influential factors for multinationals in deciding about the location of their investment** (Shah, 1995, p. 25; OECD, 2003, p. 32-35; Morisset, 2003, p.1)

- Factors influencing the attractiveness of an investment location to a greater extent than tax incentives are: *market size, availability and price of factors of production, the possibility of repatriation of profits, macro-stability in the exchange rate and increase in prices, relatively compatible legal system of the domicile country, the protection of property rights, general level of corruption, especially political stability* (Kovač, 2003)

- Earlier studies (before 90) have found out that taxes play a minor role in FDI decision (OECD, 2001, p.49-54; OECD,2003, p. 34)

- After 90’ taxes (corporate income rates and incentives) are becoming **increasingly important** (OECD, 2001, p. 55-60; OECD, 2003, p. 34; de Mooj, Ederveen, 2003)

Role of government

- The role of government in creating an appropriate legislative framework for attracting FDI is strongly emphasized in the literature

- Developers of economic policy are **faced with complex challenges** if they are to create attractive investment location and environment for foreign direct investors (Kokko, 2002)

- The country needs to build a sustainable basis for attracting new investors and to increase its impact in **retaining the current** (Benáček, Gronicka, Holland and Sass, 2000)

- The use of investment incentives focusing exclusively on foreign firms, motivated in some cases from a theoretical point of view, is generally not an efficient way to raise national welfare, unless a **SPILLOVER OF FOREIGN TECHNOLOGY AND SKILLS TO LOCAL INDUSTRY is consequence of foreign investment** (Blomstrom, Kokko, 2003)

Export-oriented FDI

- The choice of location is driven by firms finding the optimal place to combine their FSAs with locational advantages to exploit their FSAs „OLI paradigm“ (Dunning, 1993; Dunning and Lundan, 2009)

- Growing evidence that tax rates and incentives influence the location decision of companies within regional economic groupings (Morisset, 2003, p.1)

- Common markets, customs unions and FTAs had effects of reducing differences between member countries distinction between horizontal (market-oriented) and vertical (export oriented) incentives (Vlahinić-Dizdarević, Blažić, 2005)

- FDI moves from predominantly market-seeking to predominantly efficiency-seeking (export-oriented) (Radosevic *et al.*, 2003, p. 65)

Classification of incentives

- The usual classification is :“**direct” (financial)** and “**indirect” (fiscal)** incentives (Easson, 2001, p. 366; OECD, 2003, p. 39)

- **Fiscal incentives** are different forms of tax reductions→ Tax credits, tax deductions, tax reduction, exemption from customs duties, reduction of the tax base, exemption from payment of VAT

- **Financial** (soft loans, grants, state guarantees on investment loans, guarantees for export credit insurance, subsidized funds for different purposes)

- **Other** (preferential government contracts, the provision of real estate at below market prices, institutional investment incentive programs of entrepreneurship development, duty free zone, special economic zone)

FDI in the period 2001-2012

- Croatia, until 2001 almost **no special (targeted) tax incentives**, but a general very generous investment incentive in a form of equity allowance (**ACE tax – interest adjusted profit tax**)

- But its relative success in attracting FDI influenced more by its **geographical position** and its **relatively advanced economy** than to tax incentives (Vlahinić-Dizdarević, Blažić, 2005)

- Net inflow of FDI in GDP for Serbia and Croatia for the average of surrounding countries (the Region), as well as all CEE countries in the period 2001-2012, was very similar →**notable increase of net FDI before the crisis**, accompanied by decrease in the crisis period

- **Large deficits** were mainly financed by robust FDI inflows, **privatisations and follow-up investments by parent companies** were key determinants of FDI

FDI flows 2015

- Global FDI flows expanded by **36% in 2015** and reached their highest level since the financial crisis, **USD 1.7 trillion** (UNCTAD)
- FDI inflows to the CESEE declined by **26.7% in 2015** after an expansion in 2014
- The 2015 decline was as much as **43% in the EUCEE region**, **CIS+Ukraine 45%**
- Western Balkans and Turkey booked an increase of **48%**
- Croatia, Estonia, the Czech Republic, Hungary and Poland received unusually low inflows in 2015
- **Tax optimization of multinational enterprises** has become a main determinant of the economic sector and of the immediate home country of investors (The Vienna Institute for International Economic Studies, 2016)

FDI in Serbia and Croatia

- FDI in Serbia have recorded significant amounts since 2001 (in **2006** they reached **14.4% of GDP**)

- FDI inflows have had a downward trend since the beginning of the global crisis (average value of FDI inflow from 2009 to 2011 was **4.5% of GDP**)

- Serbia attracted around **USD 27 billion** of inward FDI since **2000**

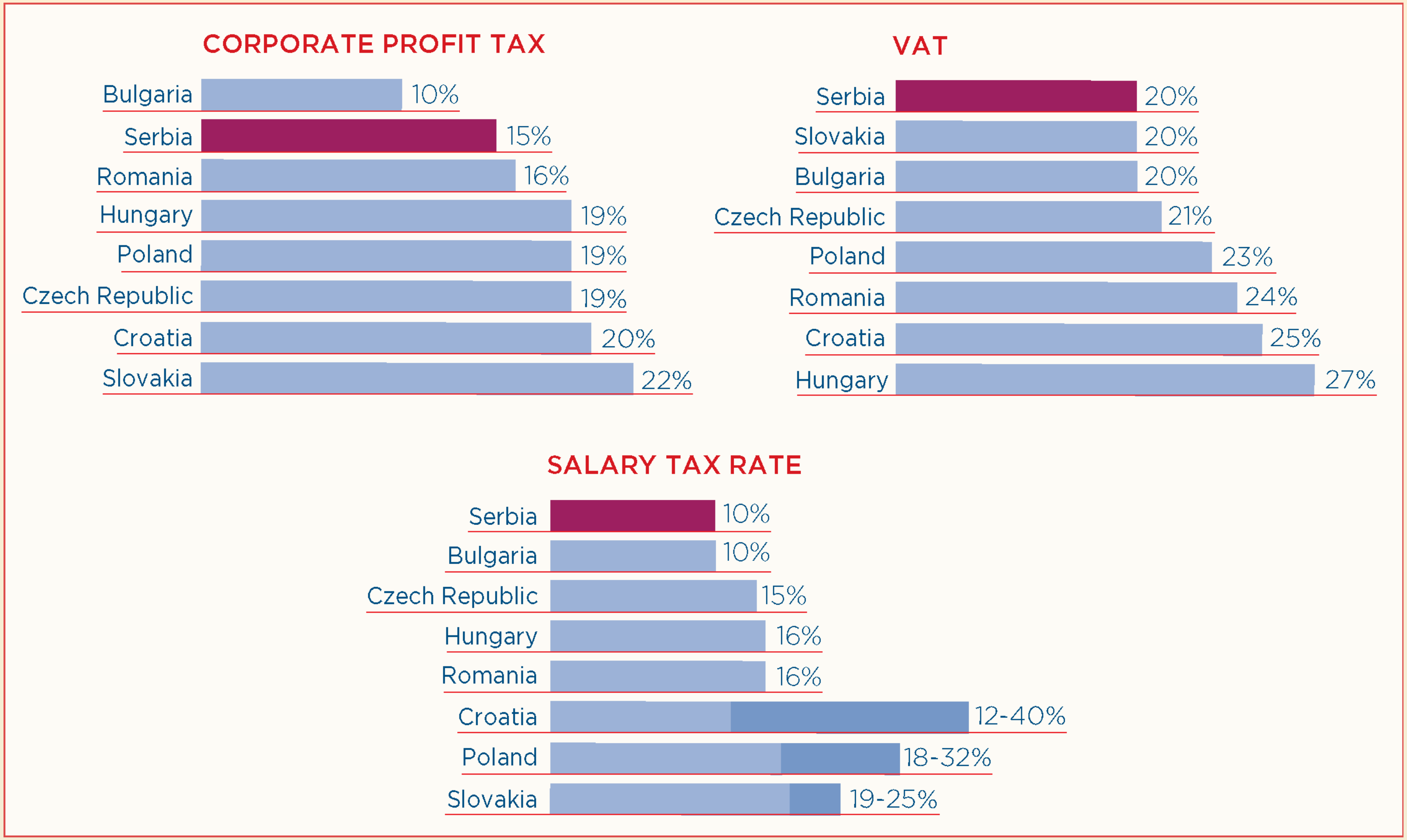
- In the period from 1993 through September 2015, FDI in Croatia totalled **EUR 30** billion

- Total foreign direct investments (FDI) in Croatia in 2015 amounted to **EUR 170 million** (Vienna Institute for International Economic Studies, 2016)

- Serbia attracted some **USD 2 bn** of foreign direct investments inflows in 2015

- FDI created **10,631 jobs** in the country in 2015 →108% percentage change compared to the year 2014 (EU’s Attractiveness survey Europe, 2016)

Taxing differences



„Doing Business 2016: Measuring the quality and efficiency of the regulatory framework“ , World Bank

Indicator	Croatia	Europe & Central Asia	OECD high income
Payments (number per year)	19	19,2	11,1
Time (hours per year)	206	232,7	176,6
Total tax rate (% of profit)	20	34,8	41,2
Profit tax (% of profit)	0	10,8	14,9
Labor tax and contributions (% of profit)	18,8	20,4	24,1
Other taxes (% of profit)	1,2	3,1	1,7

Indicator	Serbia	Europe & Central Asia	OECD high income
Payments (number per year)	42	19,2	11,1
Time (hours per year)	244,3	232,7	176,6
Total tax rate (% of profit)	39,7	34,8	41,2
Profit tax (% of profit)	16	10,8	14,9
Labor tax and contributions (% of profit)	20,2	20,4	24,1
Other taxes (% of profit)	3,5	3,1	1,7

Legislative framework for investment incentives in Croatia

1. Corporate Profit Tax (CPT) Law;

2. Training and Education Incentives Law;

3. Law on Scientific Activities and Higher Education;

4. Law on Investment Promotion and Improvement of the Investment Environment;

5. Law on Free Trade Zones (incentives expire from 1 January 2014 through 31 December 2016);

6. Law on Special State Care Areas (incentives expire from 1 January 2014 through 31 December 2016);

7. Law on Renewal and Development of the City of Vukovar (incentives expire on 31 December 2016);

8. Other.

Law on Investment Promotion and Improvement of the Investment Environment

- In order to apply for investment incentives:

- manufacturing and processing activities;
-development and innovation activities;
- strategic business support activities; or
- provision of services of high added value.

- Investment of <u>environmentally safe business activities </u>with one of the following aims:
  - introduction of new equipment and modern technologies;
  - increase of employment and education of employees;
  - development of products and services of high added value;
  - increase entrepreneurial competitiveness; or
  - stimulation and increase of economic activity in areas where economic growth and employment are below the national average (in accordance with the Croatian regional development map)

Law on Investment Promotion and Improvement of the Investment Environment

- Should the investment qualify:
  - **CPT incentives;**
  - **Capital expenses incentives;**
  - **Employment incentives; and**
  - **Labour intensive project incentives**

- All incentives, including tax incentives, can be used by companies registered in Croatia that have made investments in a minimum amount of **EUR 150,000** (**EUR 50,000 for micro-entrepreneurs**), and provide at least **5 new working places** (**3 new jobs for micro entrepreneurs**).

- According to the Law, tax incentives include reducing the **corporate income tax rate**, which depends on the amount of the investment and number of jobs created.

Profit tax incentives in Croatia

Investment amount (€ mil.)	Number of newly employed	Min.period (years) of maintaining the investment	Min. period of employment (years)	Profit tax rate
<1	5 (3 for micro)	10 (5 for micro)	3 (SME's), 5 (large)	10%
1-3	10	10	3 (SME's), 5 (large)	5%
>3	15	10	3 (SME's), 5 (large)	0%

Incentive measures can be used by enterprises registered in the Republic of Croatia investing in fixed assets the minimum amount of:

- € 50,000 together with creating at least 3 new jobs for microenterprises
- € 150,000 together with creating at least 5 new jobs for SMEs and large enterprises.

Serbian Law on Investment

- On 4 November 2015, the new Serbian Law on Investment came into force replacing the long-standing Law on Foreign Investment
- Supersedes sections of the current Law on Foreign Trade and the Law on Regional Development
- The new institutional framework →Council for Economic Development (Savet za ekonomski razvoj) and the Serbian Agency for Development (Razvojna agencije Srbije) as the key institutions
- **Investment projects for which funds can be allocated:**

Creation of new jobs	Eligible costs of investment in EUR	Classification of a unit of local government in which the investment is to be realized
20	≥ 150.000	IV group of development and the devastated areas
30	≥ 300.000	III group of development
40	≥ 300.000	II group of development
50	≥ 600.000	I group of development
15	≥ 150.000	Investment projects in the services sector, which may be subject to international trade

Government Support for Business

Investment Incentives Outline

Financial Incentives	Tax Incentives	Other Incentives
•State Grants for Greenfield and Brownfield Projects •The National Employment Service Grants	•Corporate Income Tax Holiday •Corporate Income Tax Credits •Carrying Forward of Losses •Avoiding Double Taxation •Salary Tax Social Insurance Charges Exemptions •Annual Income Tax Deductions •Value Added Tax Exemptions in Free Zones	•Customs-Free Imports of Raw Materials and Semi Finished Goods •Customs-Free Imports of Machinery and Equipment •Local Incentives

Financial incentives:

- **Incentives for eligible costs of gross salaries for new jobs** - 20% (for the I of municipalities), up to 40% (for devastated regions)
- Limited to a maximum of 3.000 (for group I), up to 7.000 euros per new jobs created (for devastated regions)

- **Incentives for eligible investment costs in fixed assets** - an increase in the amount of grants may be approved for: up to 10% (for I group) up to 30% (for devastated regions)

- **Additional incentives for labor-intensive projects** - an increase in the amount of grants : 10% of the eligible costs of gross salary (for any increase in the number of new jobs created over a number of 200 new jobs), 15% (≥500 new jobs) and 20% (≥1,000 new jobs).

Tax Incentives in Serbia

- ***Corporate Profit Tax Holiday***
  Companies **are exempt from Corporate Profit Tax** for a period of **10 years** starting from the **first year in which they report taxable profit if** exceeding approximately **€9 million in fixed assets**, and employ at **least 100 additional employees** throughout the investment period

- ***Carrying Forward of Losses***
  The tax loss stated in the tax return can be carried forward and offset against future profits over a period **up to 5 years**

- ***Avoiding Double Taxation***
  If a taxpayer **already paid tax on the profit generated abroad →Corporate Profit Tax credit in Serbia** to the already paid amount, **Double Taxation Treaty**
- Income generated through commercial activities in the Free Zones in Serbia is exempted from **Value Added Tax**.

Tax Incentives in Serbia

- ***Salary Tax Social Insurance Charges Exemptions***
  From July 1st, 2014 new employment entitles employers to a sizable relief of taxes and contributions paid on net salary from the moment of employment

- 1-9 new jobs: **65% reduction;**
- 10-99 new jobs: **70% reduction;**
- 100+ new jobs: **75% reduction.**

- ***Annual Income Tax Deductions***
  For non-Serbian citizens, the annual income is taxed if exceeding the amount of **threefold the average annual salary** in Serbia
- The tax rate is **10%** for the **annual income below the amount of 6 times average annual salary** in Serbia
- **15% for the annual income above the amount of 6 times average annual salary** in Serbia.

Conluding remarks

- Important role of FDI during the transformation of the former centralized planned economies

- In the recent years, the **effectiveness of tax incentives**, aimed at attracting FDI in developing countries, on the growth of economy has been much discussed in the scientific literature

- This is not surprising **since foreign capital has played an important role** in most countries during transition to market economy

- For CEE countries FDI was an important factor in economic growth →71% of GDP growth in these countries is owed to the inflow of FDI (Neuhaus, 2006)

- The experience from Central European economies, consistent with the empirical evidence, show that high levels of FDI bring sustained economic growth

Conluding remarks

- In addition to tax relief →financial support in the form of allocation of grants under various government programs
- Fiscal advantages to attract investors or to support investment overseas, should be extended through appropriately designed and administered incentives schemes –**sector specific, timebound, transparent and conditional** (e.g. on sustainable development contributions), within the boundaries of existing international commitments (UNCTAD, WIR,2015,p.207)
- A credible monetary and fiscal policy, a favorable business environment, competitive domestic market, anti-monopoly regulations, transparency of the legal system, implementation of the laws, protection of property rights, reduction of corruption, improvement of infrastructure, progress in European integrations (Serbia)

CONCLUSIONS

- **Stimulus packages of investment incentives attract foreign investors and lead to an increase in FDI inflows followed by an acceleration of economic growth in host countries**

- **The government plays a key role in the creation of investment incentives** (especially tax incentives) and the creation of attractive investment locations in the host country

- Croatia is **more advanced** in terms of criteria that influence the regulation of the tax obligations of companies in relation to Serbia

- Serbia applied **attractive package of tax incentives** in respect of Croatia, which significantly contributes to encouraging FDI inflows

THANK YOU FOR THE ATTENTION!