KDMT49946799

COMPETITION FOR INVESTMENT AND THE WTO REGULATIONS: COUNTRIES IN TRANSITION

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THESIS

Submitted to
KDI School of International Policy and Management
in partial fulfillment of the requirements
for the degree of

MASTER OF INTERNATIONAL ECONOMIC POLICY

Department of International Economic Policy

1999

ABSTRACT

COMPETITION FOR INVESTMENT AND THE WTO REGULATIONS:

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This work investigates various aspects of competition for FDI, such as theoretical arguments regarding investment incentives, types of investment incentives and the WTO regulations that are related to the investment incentives. It presents the current situation regarding investment incentives in the transition economies of the Central and Eastern Europe in the frame of their compliance with the WTO regulation. The main characteristics of FDI in these countries are also presented. A country providing certain investment incentives might be challenged by the WTO regulations or be subject to the countervailing measures.

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CHAPTER 1. INTRODUCTION

Two types of government intervention affect investment decisions: investment incentives and performance requirements. Incentives and performance requirements relating to the foreign direct investment began to be partly regulated in the global trading system with the settlement of the Uruguay Round. Such Government interventions may distort allocation of resources and affect trade flows, resulting in negative effects on the world welfare. Although many scholars stress the need to limit the use of incentives, they are prevalent in lots of countries.

Up to now there is no international regulations which directly limit the use of incentives as a means to influence locational decisions of investors, although the use of investment incentives that directly influence flow of international trade is restricted by the Agreement on Subsidies and Countervailing Measures in the WTO.

After examining the WTO regulations of relevance to the investment incentives, this work compares them with the current provisions of foreign direct investment regulations in the Central and Eastern European countries in transition. This work would shed light on those countries to adjust to the global trading system in the sense that all of them have relatively little experience in performing international trade based on the WTO standards and some of them are still in the process of accession to the WTO.

The structure of the current study is the following. Chapter 2 summarizes the economic arguments for and against the investment incentives. Chapter 3 describes various forms of investment incentives, discusses policy issues related to incentives and presents alternative ways to classify investment incentives. Chapter 4 describes the contents of the Agreement on Subsidies and Countervailing Measures as well as

Agreement on Trade Related Investment Measures in the WTO. Chapter 5 compares the investment incentives regime in the Central and Eastern European transitional economies with those in the WTO regulations.

CHAPTER 2. THEORETICAL ANALYSIS OF INVESTMENT INCENTIVES

2.1. Arguments for incentives

Arguments for investment incentives are much similar to those used in favor of trade protection. The main rationale for investment incentives is based on the inefficiency of capital markets. Positive effects of investment include economies of scale, technological spillovers, upgrading labor skills, knowledge and agglomeration effects. Thus, investors' costs are higher than those for the society as a whole. In the absence of compensation for such positive spillovers investors will not take externalities into account in making decisions on investment; therefore, incentives could be used to ensure efficiency in allocating resources.

The infant industry argument reflects dynamic gains from investment. Incentives correct failure of markets to reflect gains that can accrue from increasing productivity. Thus, a country can acquire comparative advantage in an expanding industry in the future.

It can also be said that incentives could offset the distortions in the labor market securing higher level of welfare by compensating producers to achieve optimal level of output and increase in employment.

Argument for incentives is based on information asymmetries as well. Information asymmetries cause investors to behave differently from the way that they had perfect information, and that leads to underinvestment. Incentives are often used to

compensate investors for additional costs caused by national laws or government policies. This might be compensation for performance requirements used in developing countries, or offsetting the corporate tax distortion. The main non-economic argument for investment incentives is related to national security issues[1].

Since the onset of the debt crisis in the early 1980s (and that observed globally since late 1990s), foreign direct investment, FDI hereafter, has come to be perceived in a mush more favourable light than in the past by developing country governments. There are good reasons for the assessment of the potential role of FDI in development. Under current conditions, FDI in developing countries have the potential for making a contribution to their development. That is, in an increasingly liberalized and globalized world, developing countries want to strengthen their competitiveness in world markets while accumulating capital, both physical and human[2]. Acknowledging such beneficial effects of FDI in development, a lot of developing countries provide investment incentives to attract FDI.

2.2. Arguments against incentives

It is difficult to measure what is the net effect of incentives for a country providing these incentives. Most of the arguments for incentives are based on various types of distortions in world or domestic markets. The main argument against incentives is that they designed to offset distortions bring even greater ones. The use of incentives to correct inefficiency in international capital markets not only fails to do so but, on the contrary, incentives increase distortions not only in capital markets but also in commodity markets and welfare distribution.

[1] For the details, see UNCTAD (1999), pp. 46 – 50.
[2] UNCTAD (1999), p. 45.

To check the effect of investment incentives we can start from a distortion-free economy. FDI represents capital flow from capital abundant country A to capital scarce country B where return on capital is relatively high. Let's define the rate of return to capital in country A as r_A and that in country B as r_B, where $r_A < r_B$. Capital flows to country B until $r_A = r_B$. Both countries gain as they would gain from free trade. In country B capital-intensive sector expands and relative prices of capital-intensive goods drop. Country A enjoys higher return on capital which can be exchanged to goods produced in country B and prices of labor-intensive goods decrease.

For country B there is no reason to use investment incentives since capital flows into itself anyway. If country A wants to curtail capital outflows it might impose incentives to equalize return on capital in both countries. Then capital outflow would stop and the above-mentioned gains will not be realized.

We can also think of the case that investors in country A require risk premium "x" over r_B before they invest in country B (it could be due to various reasons). Capital would flow into country B until $r_B - x = r_A$. To attract investment country B provides an incentive which increases return to capital in that country. Thus, taxpayers in country B subsidize the premium return to investors from country A.

Countries tend to be involved into competition to attract investment. Competing for investment, governments tend to pay the amount equal to the social benefits derived from investment. That is much greater than the optimal value of subsidy, which is supposed to be the difference between social benefits and private benefits. Overbidding for investment may bring two kinds of adverse consequences. First, the poorer countries are able to provide relatively less incentives than the richer ones so they are likely to be losers in such competition. Second, even if a country

succeeds in attracting investment, costs tend to be much higher than the case of the absence of competition for attracting FDI.

We can also think of the redistribution effect of investment incentives.[3] First, for investors who would have invested regardless of availability of incentives, incentives represent pure transfer payment from national government to the private sector concerned. Second, the majority of the multinational corporations originate from the developed countries, thus developing country providing incentives actually transfers welfare to the developed countries. Third, the costs of incentives spread evenly in the society, but benefits often accrue to certain groups (depending on geographical location, occupation...) thus incentives are subject to lobbying activities. Fourth, they usually discriminate between small enterprises and large multinational corporations (MNCs). The most obvious discriminatory practices would be the negotiated incentives, though discrimination can occur in other aspects as well.

2.3. Competition for investment

The most convincing argument supporting the use of incentives is based on the existence of positive externalities from investment, although the methods measuring the externalities are not reliable. The externalities from investment are associated with technology transfer and job creation from FDI flows.

To prove that positive effects from technology transfer exist, it should be demonstrated that the new technology was transferred from investor to the host country. It means that other economic agents in the economy are gaining this knowledge. Transfer of knowledge within the company is not a positive externality

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[3] For further details see UNCTAD (1996).

itself, because benefits from the transfer are fully captured by itself. It is almost impossible to measure benefits to other agents in the economy.

Assuming that incentives may attract investment which increases national welfare, national governments are involved in competition for investment. The governments considering to provide incentives must consider the possibility that other governments also apply similar policies to attract investment. Host countries face a situation known as "prisoner's dilemma". All countries mutually gain if they would refrain from giving incentives, but each individually gains by providing incentives irrespective what other countries would do. Investors take advantage of such competition among governments.

Not rejecting the possibility that incentives sometimes could be helpful for increasing national welfare, they result in decrease of the world's welfare as a whole due to the distortive effects, and these distortions increase when countries compete for investment by providing incentives. Internationally accepted rules on the use of incentives therefore seem to be beneficial to all countries. Until 1994 there was no international regulation dealing directly with investment incentives, but currently the provisions of the Agreement on Subsidies and Countervailing Measures in the WTO limit the use of incentives.

CHAPTER 3. THE WTO PROVISIONS ON INVESTMENT

Although there is no global regulations designed specially for FDI incentives, the Agreement on Subsidies and Countervailing Measures and Agreement on Trade Related Investment Measures (TRIMs Agreement) in the WTO are related with the investment incentives. Despite the efforts to establish the rules on the use of

investment incentives in the name of the Multilateral Agreement on Investment (MAI) in the OECD framework, the negotiators could not arrive at a consensus. Therefore, as of mid-1999 the WTO provisions remain the only effective means dealing with FDI incentives in the global trading system.

3.1. Agreement on Trade Related Investment Measures

The Agreement on Trade Related Investment Measures, the TRIMs Agreement hereafter, designed to protect interests of investors places main emphasis on the elimination of certain investment disincentives. The Agreement prohibits measures that are inconsistent with the provisions of Article III or those of Article XI of GATT 1994, namely the national treatment principle and prohibition of quantitative restrictions. As defined in the Illustrative List in the Annex to the Agreement, local content requirements or import balancing requirements are strictly prohibited.

3.2. Agreement on Subsidies and Countervailing Measures

The contents of subsidies and investment incentives and their effects on trade are very similar. In most cases FDI incentives are used to attract capital inflow, while subsidies support existing production. However, after investment has taken place, the role of incentives becomes the same as that of subsidies. Therefore, investment incentives are regarded as subsidies and rules on the use of subsidies can be applied to investment incentives as well. This section describes the characteristics of the Agreement on Subsidies and Countervailing Measures, the SCM Agreement hereafter, in the WTO.

The key issues in the Agreement are definition, classification of subsidies and provisions of precise guidelines for determination of serious prejudice and injury.

Clarification of the terms, assurance of a higher level of transparency in use of subsidies affecting international trade as well as the establishment of comprehensive procedures of invoking of countervailing measures can be regarded as significant improvements in regulations on subsidies as well as investment incentives in the global trading system.

3.2.1. Definitions of subsidies

Subsidies are defined in the SCM Agreement as:

1) financial contribution by a government in the form of :

- Direct transfer of funds (loans) or potential direct transfers of funds or liabilities (guaranties);
- Government revenue that is otherwise due is foregone or not collected (fiscal incentives);
- Provision of goods and services other than general infrastructure, or purchases of goods;
- Financing, entrusting or direction of a private body to carry out any of the actions mentioned above.

or

2) any form of income or price support and a benefit is thereby conferred (Article 1 of the Agreement).

Shortly, subsidy is a financial contribution by government which confers a benefit to the receiver. The term "financial contribution" should be understood as a form of government intervention which involves some expenses to the government whereas there is no clear explanations on the "benefit".

To be subject to countervailing measures subsidy should meet "specificity" requirements. "Specificity" means that granting authority or legislation either explicitly or not explicitly limits access to a subsidy to a certain types of industries or enterprises. There are two types of specific subsidies which do not exactly meet the above mentioned requirements. If subsidies are distributed among different industries, but they are linked to export or import substitution, within understanding of Article 3 of the Agreement, these subsidies should be considered as specific as well. The other type falling under the category of specific subsidies is regional subsidies which are limited to enterprises "located within a designated geographical region within the jurisdiction of granting authority". Thus, all regional subsidies are specific except those granted for disadvantaged regions which are categorized into non-actionable subsidies. Specificity is the main precondition for allowing a subsidy to qualify as actionable and a fundamental term in the SCM Agreement. Unfortunately, the definition of this term lacks clarity and consistency, that makes interpretation of the provisions of the Agreement in various ways.

3.2.2. Subsidies by types

The Agreement classifies all subsidies into three categories: prohibited, actionable and non-actionable subsidies.

- Prohibited subsidies -

The Agreement prohibits export subsidies and import substituting subsidies. Export subsidies are defined as those which in law or in fact, are tied to export performance. The additional explanations of export subsidies are provided in an illustrative list. The list includes the following measures: Currency retention practices

which involve bonus on exports (more favorable exchange rate for exporters); Subsidies on internal transport and freight charges on export shipments; Provision by governments, directly or not, of imported products or services for use in production of exported goods, on terms more favorable than for production of goods for domestic consumption, if such terms are more favorable than those on world markets to their exporters; Tax concessions, reduction of social welfare charges, or other fiscal exemptions specifically related to exports; The exemption or remission in respect of production and distribution of exported products of indirect taxes in excess of those levied in respect of production and distribution of like products sold in domestic market (value added tax); Prior-stage cumulative indirect taxes; The drawback of import duties in excess to those levied on imported inputs that are consumed in production of the exported product; The provision by government of export credits cheaper than market price, guaranties, insurance, exchange risk programmes at premium rates, which are inadequate to cover costs and losses of the programmes; The grant by government of export credits at lower than market prices or covering costs of obtaining export credits (Article 3. (a) of the Agreement).

The import substituting subsidies are those granted under condition of using domestic goods over imported ones. This category of subsidies includes only subsidies which are legally tied to import substitution, and does not embrace subsidies which intend to displace imports in fact (Article 3. (b) of the Agreement).

- Actionable subsidies -

Actionable subsidies include all subsidies which are not prohibited nor non-actionable subsidies. To be subject to countervailing measures the subsidy should be

specific and cause adverse effects to the interests of other Members. Adverse effects are defined as :

- Injury to the domestic industry of another Member;
- Nullification or impairment of benefits accruing to other Members under the WTO; and
- Serious prejudice (or threat) to the interests of the another country.

Findings of injury must be based on the positive evidence of material injury caused by increased volume of subsidized imports. "Material injury" also includes threat of material injury. Nullification and impairment are associated with the deviation by subsidizing country from its obligations of established level of market access. Serious prejudice is directed to certain kinds of subsidies which are considered as containing prejudice to foreign enterprises. If affected country submits a complaint that serious prejudice exists, the proof shall be based on the negative evidence from subsidizing country. There are two groups of indicators determining which subsidies involve serious prejudice. The first one is related to content and nature of subsidies. These are the following:

a) Subsidies exceeding 5% of ad valorem; b) Subsidies to cover operating losses sustained by an industry; c) Subsidies to cover operating losses sustained by an enterprise, other than one-time measures in order to provide time for the development of long term solutions and to avoid acute social problems; d) Direct forgiveness of debt and grants to cover debt repayment (Article 6.1 of the Agreement). Annex IV to the Agreement gives guidelines for calculation of the total ad valorem subsidization. Subsidy should be calculated as the cost to the granting government. The value should be calculated as the total value of the recipient's sales in the most recent 12-month

period. Special provisions are given if recipient firm is in a start up situation, if the firm is located in inflationary economy.

The indicators in the second group are based on the effects of subsidies. Serious prejudice is deemed to exist if the effects of the subsidies are: a) Displacement or impediment either imports of a like product of another member into the domestic market or exports from a third country market. This should be understood as change in relative market share to the disadvantage of non-subsidized product. If displacement and impediment is stipulated by commercial policies of the complaining country or other internal factors in that country it should not be considered as indicators of serious prejudice in providing subsidies; b) Significant price undercutting compared to that of another Member in the same market, or price suppression, depression or lost sales. Such undercutting can be demonstrated through comparison of prices of subsidized product and prices of non-subsidized one; c) An increase in the world market share of the subsidizing Member in a particular subsidized product (Article 6.3 of the Agreement).

- Non-actionable subsidies -

Subsidies are non-actionable if they are not specific, or which are specific but are provided to finance either of the three types of programs:

a) Assistance for research activities if the assistance covers not more than 75% of the costs of industrial research (search aimed at discovery of new knowledge) or 50% of the pre-competitive development activity costs (translation of industrial research finding into a plan or design for new or improved products, but not further design of products that could be converted or used for industrial application or commercial exploitation, not periodic alterations to existing

products). Such assistance could be granted only to cover costs of personnel and other costs incurred directly as a result of research activity;

b) Assistance to disadvantaged regions given pursuant to regional development programs, provided that subsidies are non-specific within the region. Such region should be clearly defined. It should be used by objective and neutral criteria in determining that region to be disadvantaged. Criteria should reflect either income per capita (not more than 85% of the average) or unemployment (not less than 110%);

c) Assistance related to imposition of new environmental requirements. The assistance should be one-time measure not exceeding 20% of costs. It should not cover any manufacturing cost savings and should be available to all firms that can adopt the new equipment (Article 8.2 of the Agreement).

Subsidy programs should be notified in advance of its implementation to the Committee on Subsidies and Countervailing Measures in the WTO. The notified subsidies can not be subject to countervailing actions unless the Committee or arbitration body determines that the program does not qualify for status of non-actionable subsidies. If the concerned subsidy program is not notified it is not protected from retaliatory actions. However, non-notification does not prevent defending party from proving that subsidies are non-actionable. The Agreement provides for the exception when non-actionable subsidies could be challenged. This is the case when the WTO Dispute Settlement Body determines that such subsidies cause serious adverse effects to other Member and the damage would be difficult to repair (Article 9 of the Agreement).

3.2.3. Remedies and Countervailing Measures

The WTO remedies against subsidies are designed to eliminate subsidies or their adverse effects at the source (subsidizing country) and they can be directed against subsidies affecting any market. A countervailing measure may be imposed in order to neutralize effects of subsidized imports only in the own market.[4]
The rules concerning remedies against prohibited or actionable subsidies in the Agreement provides for consultations between affected countries and subsidizing country. If consultations do not produce a mutually agreed solution the matter is referred to the decision of the Dispute Settlement Body. The DSB determines whether the subsidy is prohibited or that having adverse effects or not. If its decision is positive and the subsidy is not withdrawn nor modified, the DSB gives authorization to the affected Members to apply appropriate measures to eliminate adverse effects.

The main requirements of imposition of countervailing measure are demonstration of the existence of a subsidy and material injury to the domestic producer and causal link between the subsidized imports and the injury. For measurement of subsidy the greater emphasis is laid on benefits of the subsidy to the recipient rather than subsidy cost for subsidizing government. Article 14 provides guidelines for calculation of the amount of subsidy in terms of the benefit to the recipient: Government provision of equity capital should not be considered as a benefit, unless investment decision can be regarded as inconsistent with usual investment practice in that country; Government's loan should be considered as a benefit if receiving firm pays less than comparable commercial interest rate. The same is in case of a loan guaranty by government; The provision of goods or services or purchase of goods or services by government should be considered as benefit if the price of goods or services is different from market price.

The Agreement provides more favorable treatment for developing countries and countries in transition to a market economy with respect to subsidies disciplines (Articles 27 and 29 of the Agreement).

CHAPTER 4. FORMS OF FDI INCENTIVES

In the 1990s developed countries usually do not differentiate between domestic and foreign investors in providing investment incentives. Most of these countries promote investment into manufacturing with high value-added and high technology. Some countries are attracting companies to locate their specific corporate functions. Competition for investment takes place not only among countries but also among regions within a country. In developing countries and countries in transition incentives are often used as means to attract investment, regardless of its type. FDI incentives are in general classified into the following three categories: financial incentives; fiscal incentives; and other (indirect) incentives.[5]

4.1. Financial incentives

A financial incentive is a transfer of financial assets to investor from state funds. This transfer can occur in a form of actual payments or potential payments. Actual payments could be grants, loans at reduced interest rates and equity infusions. Potential payments are loan guarantees and risk insurance. Such incentives often are provided under certain conditions and could be canceled if the conditions are not met.

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[4] Countervailing duties basically originate from GATT Article VI.
[5] See UNCTAD (1996), pp. 3-7

Financial incentives are often associated with education of employees and development of infrastructure.

4.2. Fiscal incentives

A fiscal incentive is a release of overall tax burden for investor, thus increasing the rate of return to the investment. These could be reduction of corporate income tax, tax holidays, exemptions from custom duties on imported capital goods or production inputs, accelerated depreciation, investment and reinvestment allowances, reduction of social security contributions. Fiscal incentives are the most widely used type of incentives. These are very popular among developing and transitional countries because they do not require accumulation of additional resources by public authorities. Most incentives offered are intended to stimulate specific type of investment such as investment in priority industries, less developed regions, production for export and intangible assets.[6]

Provision of various fiscal incentives alone does not necessarily make a country attractive in terms of taxation. The effective tax rate depends on general level of taxes in the country, as well as the inflation rate, nominal interest rate and accounting system.

4.3. Other (indirect) incentives

Other incentives, not included in the above-mentioned categories, mainly are the provision of subsidized services, infrastructure and technical support. Governments establish science parks, free economic zones, export-processing zones and so on,

[6] See UNCTAD (1996), , pp. 3-7 and A. Shah, (1996), pp. 32-37.

where they offer various measures supporting investors. Such incentives are focused on regional development and technology transfer. Another form of incentives is a special provision of foreign exchange to protect from risks arising from fluctuations of exchange rate. Some countries provide protection from import competition or even from domestic competition.

4.4. Alternative Ways to Classify Investment Incentives

There are other types of classifying of investment incentives as well:

a) Direct and indirect investment incentives

Incentives are classified depending on whether they are received directly by the investor or not. Direct incentive may be in the form of a fixed amount per unit of investment or ad valorem. Indirect incentive may be provision of inputs, including capital, for lower than market price or assurance of price higher than market price for its output.

b) Financial (or explicit) and implicit investment incentives

Financial incentive is a transfer to investor in the form of budgetary expenditure. Financial incentives include tax expenditures which are various forms of tax reductions or exemptions. Implicit incentives may be given in the form of provision of subsidized inputs, infrastructure, information or regulatory actions that change market prices or access in favor of investor.

c) General or sector specific, industry or firm specific investment incentives

Incentives may differ depending on whether it is available to all companies or it is available only to a certain group of companies or industries. In the WTO SCM Agreement "specificity" is one of the main indicators in determining whether the subsidy is actionable or not.

d) Unconditional and conditional incentives

Incentives which are provided only if the investor commits himself (herself) to comply with certain requirements (such as export performance, local content and employment) are conditional incentives. The unconditional incentives are granted only if investment has been undertaken.

e) Incremental and non-incremental investment incentives

Incremental incentives are directly related to the amount of the investment undertaken. If the total amount of incentives is unrelated to the amount of investment such incentives are non-incremental.

f) Local and national investment incentives

This type of classification is based on the level of authorities providing incentives. Competition for investment exists not only among states but also among districts, regions or cities within states. Thus local investment incentives are these offered by local authorities.

4.5. Effects of incentives on locational decisions of investors

It is difficult to estimate what impact incentives have on locational decisions of investors, because such decisions are very complex and it is difficult to separate effects of incentives from other factors. However, most researches have come to the conclusion that the incentives make very limited impact on the companies' decisions on the locations of FDI.[7] When countries compete for investment, incentives offset each other decreasing the importance of incentives. The incentives can be influential in choosing the location of FDI within selected country, but still they are not the main

[7] Most empirical research suggests that incentives are relatively minor factor in the locational decisions of investors, for example, *UNCTC,1992; Galenson, 1984; Guisinger, 1992; UNCTAD, 1996.*

factor. The impact of incentives on international trade is more evident. This could be the reason why policy makers pay very little attention to the distortive effects of incentives on FDI allocation.

CHAPTER 5. FDI INCENTIVES IN THE TRANSITION ECONOMIES

5.1 FDI flows into the transition economies

Data on FDI flows into transition economies differ a lot depending on the sources. Though the numbers provided in publications of IMF, OECD, national or regional statistics are different, the basic tendencies are very similar regardless of the source of the data.

As of the early 1990s the Central and Eastern European economies became opened for foreign investors. However, foreign investors were quite cautious about the investment in these countries. Only Hungary managed to attract significant amounts of FDI (see Table 1). Russia and Poland were the other largest recipients of FDI until 1995, which was mainly due to the size of their economies. Only after the political and economic situation has stabilized, investors showed more interest to the transition economies and FDI flow tripled in 1995. The major recipients were the big-sized economies except Ukraine and Romania, which failed in market reforms creating favorable climate for investment. After a slight fall in 1996, FDI flows into the transition economies has continued to grow.

Hungary, which was the leader in attracting FDI in the first half of the decade, is experiencing continued decrease of FDI inflow in the second half of the decade. Though in 1997 Russia experienced a remarkable FDI growth, capital inflow

drastically decreased in 1998 due to the financial crisis. FDI flow into Poland has steadily increased, that made the country the largest recipient of FDI among the transition countries (Table 2). FDI flow into Baltic States, Latvia and Lithuania accelerated remarkably after privatizing the large state-owned companies in 1997 – 1998. In 1997 Bulgaria and Romania received very large amount of inflows of FDI compared with the previous years, though in 1998 such trends were not sustained. The recent, considerable increase of FDI in Slovakia might be attributed to the political changes.[8]

Since the economies concerned are very different in their size, the trend of FDI inflows could be checked by looking at the data presented in relative terms. The data adjusted by the size of economies show the relative distribution of FDI in the countries concerned and the relative importance of FDI in these economies. Table 2 shows FDI per capita and FDI in per cent of output.

Hungary is an obvious leader with respect to FDI per capita, which more than doubles those of the Czech Republic, Poland and Slovenia. This group of countries started transformation to the market economy the earliest among all the countries concerned and Hungary was the leader within this group. Lithuania and Latvia are lagging a little behind this group, though as we can see from Table 1, FDI flows into these countries are accelerating very fast. FDI per capita in Bulgaria, Romania and Slovakia is less than half of that of the Baltic States. The worst performances are found in Russia and Ukraine. Though FDI inflows in nominal terms are comparable to those of the other transition countries, due to the high population, FDI per capita is very low there.

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[8] Business Central Europe statistical database 1999.

In the countries that have the highest FDI per capita, FDI is playing relatively important role in the economy, as the FDI inflow amounts to at least 3 per cent of GDP. The exception is Slovenia, where GDP per capita is the highest among the transition economies, and, therefore even relatively high FDI inflow is relatively low in terms of FDI inflow / GDP. In Czech Republic and Hungary, the importance of FDI is decreasing while in Latvia and Lithuania FDI is becoming more important. In Russian and Ukrainian economies FDI is still negligible. In Bulgaria and Romania FDI became more important during 1997 – 1998 and is currently similar to that of the first group of countries. FDI inflows are accelerating in most of these economies or are sustained after reaching considerable levels. Excluding Russia and Ukraine, FDI distribution in the region has become more even. These countries are not only in the process of transition, but also in process of accession to the EU and that is the reason government policies in these countries are becoming similar and so are overall trends in these economies.

When FDI per capita of transition economies is compared to that of developed countries[9], the difference is very large. Even in Hungary it is remarkably below the average of that of developed countries, although the importance of FDI in the transition economies is rather similar to that of developed countries.

The uneven distribution of FDI among transition economies reveals certain tendencies in FDI flows into the transitions economies. Among others, as observed in UNCTAD report[10], investors are giving preference to the countries that are more successfully transforming to the marked-based economies. Russia and Ukraine are the least flexible in making reforms and that is reflected in low FDI level in these

[9] UNCTAD 1998, p. 281.
[10] UNCTAD 1998, pp. 275-276.

countries. On the other hand, the countries that started reforms earlier than the other countries attracted the largest amounts of FDI. The other, quite obvious factor that explains FDI inflows is privatization of state-owned enterprises. That explains why in certain countries FDI inflow is very volatile.

The UNCTAD survey[11] on factors enhancing and constraining FDI in Central and Eastern Europe reports the view of investment-promotion agencies of these countries. In their opinion lack of investment incentives is one of the main factors limiting FDI inflow, and therefore they expect that in the future financial incentives should be provided more extensively.

The effectiveness of investment incentives in the Central Europe was also discussed in the report prepared by VVMZ East European Investment Service.[12] The study was limited to five countries: the Czech Republic, Hungary, Poland, Slovakia and Slovenia; and was based on the survey of the investors' opinion. The results of the research showed that investment incentives and intervention in trade are minor factors in influencing investor's decision. As are shown in Table 3, the most important factors for foreign investors are legislation, macro-economic situation, and political stability. The survey results indicated the importance of FDI incentives. It was found that the investors prefer fiscal incentives. The most desirable among them are investment allowance, accelerated depreciation and tax reduction on the import of capital goods. The results also indicate similar tendencies concerning importance of the investment incentives in investors' decisions in the transition economies to the research results on this issue in other regions.

[11] UNCTAD 1998, pp. 286-288.

5.2. Incentives in the transition economies

The reason for choosing the Central and Eastern European transition economies as an example how investment incentives are used in practice is that these countries are very active in providing investment incentives. After the collapse of the Soviet block, former socialist countries had to adapt themselves to the new circumstances. Planned economies could not be maintained any more due to its economic groundlessness and new liberal political regime. In order to perform transition to market economies these countries needed technologies, capital and other resources. In such situation FDI inflow was extremely important for successful transition and economic growth. That is the reason transition economies have promoted the FDI inflows.

It is very difficult and complex task to describe all investment incentives available in transition economies. These difficulties arise from certain peculiarities more or less characteristic to all these economies together with the complicated investment incentives per se. National laws, including those regulating foreign investment, are subject to frequent changes. Legal systems are complicated and sometimes are contradictory to each other. Typically, the national legal system is a mix of old laws, that have been applied as far back as in the period of planned economy, and new laws, that are made in accordance with the Western standards. What is common in these countries is that certain incentives are offered to the investor individually, after the negotiation between the host country government and the potential investor. Thus, the use of incentives lacks transparency in many instances because the agreements between the government and the investors are confidential.

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[12] See VVMZ East European Investment Service, "Study on Trade Policy and Investments", Phare, June 1997.

Tables 5 to 7 present the fiscal incentives granted to foreign investors in the Central and Eastern European economies. The data were drawn from the national laws, announced in official publications of the concerned government authorities. From the tables we can see that fiscal incentives are dominant in transition countries. Certainly, it does not entirely reflect real practices, because financial and other incentives do not necessarily need to be defined in laws (that is quite implicit in case of taxes). Financial and other incentives are easier to obtain for powerful foreign investors through negotiations and differ from case to case, although sometimes large investors are able to affect decisions of national legislation bodies in favor of their needs. However, predominance of fiscal incentives is a natural phenomenon in the countries that are scarce in financial resources.

Even if incentives are not directly related to certain requirements, they usually are targeting GDP growth, development of certain industries, export growth, creation of employment and regional development. Greenfield investment[13] is regarded as the most desirable for the governments of these countries and is reflected in the forms of incentives provided.

It is worth mentioning that, despite the strong competition for FDI inflows among the transition economies, the number and forms of incentives offered for the investors in some of these countries are decreasing. This fact might be interpreted in the sense that the transition period of these countries is coming to the end, or at least to the other stage. The government authorities are becoming more careful to the costs and benefits of the FDI inflows as they are gaining more experience and more self-confidence. For example, previously most of these countries had some preferential

[13] Investment that induces entirely new projects.

treatments specific to the foreign investors. Nowadays the domestic investors are treated the same as the foreign investors in most cases.

5.3. Financial incentives

Financial incentives are rarely used in the transition economies, but it is likely that in the future they will become more prevalent, as the economies grow continuously and the budget situation becomes healthier enough to finance such incentives. At the moment, only the Czech Republic, Hungary, Poland and Slovenia are able to provide significant financial incentives for investors. These countries have the highest GDP per capita in the region and that is reflected in their ability to provide financial incentives. In other countries, such as Russia and Ukraine, there is a possibility to obtain financial support, but actually their budgets are in huge deficit and there is no resources to provide grants or other forms of financial incentives for investors (Table 4). As in case of fiscal incentives, financial subsidies also tend to be provided only in the production sector.

The most popular of the financial incentives is state guaranty to investment loans in the transition economies. This is predetermined by the specific feature of such incentives – there is no need to accumulate financial resources prior to provision of this subsidy. Such incentives, especially in the early 1990s, were very popular in the transition economies. Certainly financial capital have been distributed not efficiently, and later, when the governments had to pay for these guarantees, provision of such subsidies was restricted. Currently interest subsidies, preferential credits, interest free loans, non-repayable grants are available in most of the countries, but the amounts of these subsidies are negligible.

All incentives of this type might be regarded as actionable subsidies since in most cases they are negotiable, there is little transparency in provision of such subsidies, and that is in conformity with the definition of the specificity in Article 2 of the SCM Agreement. In most countries there is no clear criterion set for obtaining financial support from government. In Russia preferential grants are provided, as stated in Government regulation, only for projects that are considered highly economically efficient. However, this may not be an objective criterion, either.

Some countries in the region already started and some others are in the process of setting regulations and institutions to provide financial subsidies related to exports, particularly export credits and export insurance. Insurance against risks of non-payment by foreign customers and export credits on more favorable terms as commercially available are prohibited subsidies according to Article 3.1. of the SCM Agreement. As listed in Annex I to the SCM Agreement, export credit guarantee and export insurance programs are export subsidies.

Every country has certain institutions to provide assistance for investors and exporters. Normally services provided by such institutions can not be considered as actionable subsidies since they do not have any substantial effect on price of goods produced or exported. However, when such institutions provide direct financial assistance to exporters, as it does in the Czech Republic, Latvia and Slovenia, it could cause some disputes and possible counteractions.

There are financial incentives designated for specific activities or specific sectors; for example, job creation grants, job training grants, R&D grants, environmental protection-related grants, and grants for construction of infrastructure. Often there are established special state funds, assigned to implement certain government programs and projects related to employment, environmental protection,

regional development and other social issues. Such incentives can hardly be actionable unless they have significant impact on the price of the products.

There is less transparency in the provision of financial incentives than in the provision of fiscal ones. Therefore, it is more difficult to collect credible information concerning the use of such incentives. On the other hand, there are reasons to regard such incentives as actionable subsidies in many cases since it is quite likely that discrimination among companies may arise and subsidies provided might be specific.

5.4 Fiscal incentives

5.4.1. VAT, import duties and fees

- Exemptions on imported capital contributions -

Most of transition countries provide exemptions from VAT, import duties and fees on imported capital contributions or any fixed assets imported by investor (Table 5). Such incentives, if they are not subject to additional conditions, can be regarded as non-actionable subsidies, since there is no specificity within the understanding of Article 2 of the SCM Agreement. These incentives are likely to be linked to investment rather than to trade and therefore the WTO regulations can hardly restrict their use.

Exemption from duties and taxes in relation to the value of imports which is found in Bulgaria may be regarded as a specific subsidy, since there is discrimination among enterprises, not based on objective criterion. Promotion of imports of goods belonging to the OECD list, applied in the Czech Republic, is discriminatory with respect to enterprises, producing goods not included in the specified list, and

enterprises that use machinery in their production different from the listed one. In that regard, it can be categorized as specific subsidy within the understanding of Article 2. If these subsidies exceed 5 % of total ad valorem, according to Article 6.1 (a) of the SCM Agreement, they fall under the category of actionable subsidies.

- Exemption on imported materials and components –

Exemption from VAT, import duties and fees on imported materials and components are not very popular forms of investment incentives in transition economies. That might be so because most countries have special provisions for temporary importation, duty drawback, that have quite similar effects as the incentives mentioned above. Another reason is that raw materials into most of these countries can be imported freely (tariffs are at 0% rate) and import tariffs on components are low. Such incentives are available in Bulgaria, Romania, Slovakia and Russia, i. e. the countries that are exporters of raw materials themselves and therefore are maintaining duties to protect their own producers. These incentives, like most other fiscal incentives, may fall under the category of actionable subsidies if they significantly affect price of products that might be regarded as serious prejudice to the interests of other Members within the meaning of Article 6 of the SCM Agreement.

- Exemption on exported goods -

Exemption from custom duties, VAT and/or excise tax on exported goods is available in most of the countries concerned and this incentive is not regarded as subsidy within the meaning of Article 1, since these taxes are related to the sale for the domestic consumption.

- Exemption on services related to exports -

Exemption from VAT on services related to exports is provided in Latvia, Lithuania, Slovenia and Ukraine. This incentive may be regarded as prohibited subsidy since it reduces costs of exported goods, thus promoting exports (Illustrative List of Export Subsidies, Annex I(d) of the SCM Agreement). It is worth mentioning that exemption from VAT on services that are exported should not be regarded as a subsidy (in the same way as exemption from VAT on exported goods).

5.4.2. Corporate tax relief / holiday

Generally the rationale for reduction of corporate tax is to compensate for investment-discouraging tax system. Corporate tax holidays were quite popular form of investment incentive at the initial stage of transformation from planned to market economy. After the conditions for investment had improved, use of such incentive became unjustifiable, and most governments removed this incentive. Although some companies that invested during the initial stage of transformation still benefit from corporate tax relief that was offered during that period, these incentives will expire gradually. Although most countries apply certain corporate tax preferences for enterprises employing handicapped persons, enterprises specializing in agricultural activities and small size enterprises, that is related to implementation of government policies related with social issues.

Partial corporate tax relief is offered in all countries under consideration and that is likely to be a consequence of competition for investment in the region. The magnitude of corporate tax relief varies among the countries. Typically, the larger amount invested, the greater is tax relief. Most countries promote only investment into manufacturing. Moreover, there are some restrictions for investment into service

sector. Usually, provision of incentives of this kind is based on certain criteria such as creation of jobs, revenue growth, export growth and others (Table 6).

In Latvia, Lithuania, Poland, Slovenia and Ukraine corporate tax relief is available only for investment in special areas, designated by governments (except for incentives provided for enterprises employing handicapped persons, enterprises specializing in agricultural activities and small enterprises). To be eligible for the relief, investor should meet certain criteria related to export performance (in Latvia, Poland and Slovakia), employment, or revenue growth (in Poland).

Provision of tax subsidies on the basis of export performance obviously contravenes the WTO regulations. According to the Polish regulations, incentive is provided under condition that export earnings account for more than 50% of total sales or revenue from exports exceeds ECU 8 million. According to Latvian laws, incentive is provided under condition that export earnings account for not less than 80% of total output. Such subsidies are prohibited according to the Article 3 of the SCM Agreement since they are related to export performance. Provision of such subsidies is also a violation of the TRIMs Agreement. However, as provided in Article 29, countries transforming into market economy may temporarily apply prohibited subsidies until the year 2001. Poland has notified the existence of the export-related subsidies to the WTO Secretariat, and according to the provisions of the SCM Agreement, that makes these subsidies non-actionable for a while. In Slovakia tax relief is provided under the condition that annual export growth amounts to more than 25%. This incentive is provided within all territories of the country, not restricted to certain districts designated by goverments. Such incentive is also export subsidy, similar to these provided in Poland and Latvia, and may be subject to the WTO remedies.

Lithuanian and Ukrainian laws do not establish additional conditions other than the minimum amount of investment for obtaining relief. This condition can hardly be regarded as containing specificity, thus this would not be a valid reason for application of the WTO remedies. Although it contains discrimination against smaller economic agents, providing less favorable condition for them, it does not contravene the WTO rules. Most transition countries provide corporate tax relief in relation to the amount invested. However, most of them also maintain special programs to support small and medium size enterprises, and that compensates for incentives provided only to the large investors.[14] This implies that national authorities have no clear understanding what actually they want to achieve by providing incentives.

The Czech Republic, Hungary, Slovakia and Romania provide 100 % corporate tax holiday. That is not limited to certain districts. The Czech Republic introduced anew tax holidays system recently, due to intensive competition for investment in the region and significant fall of growth rate of the economy. Some 5 year corporate tax holidays for investors in industry is available in Romania, provided that investment exceeds certain amount. Hungarian laws establish a set of requirements such as revenue growth, increase of employees and amount invested. In Slovakia, as mentioned above, provision of tax relief is based on export performance as well as the amount invested and revenue growth. It is provided only if investment is made into manufacturing sector. Such incentives affect price of the product, increase competitiveness of producers located in the country and may contain serious prejudice to the interests of others within the meaning of Article 6 of the SCM Agreement.

[14] Large investors are more likely to invest sufficient amount to obtain the tax preferences, though small enterprises obtain preferences within the frame of the mentioned programs.

However, it can hardly be regarded as specific subsidy thus, it would not be actionable one.

Partial corporate tax relief is provided in Bulgaria if investors fulfill certain conditions. In Bulgaria these conditions are related to employment and amount of investment. According to Article 2.1. (b), the number of employees is an objective criteria; therefore such subsidies are not specific. Thus, the incentives related to employment can hardly be regarded as actionable.

The situation in Ukraine is rather different. The investment surroundings are one of the worst in the region, legislation is very complicated and subject to frequent changes (during the last seven years there were four major changes in laws governing foreign investment). Even though the Ukrainian government adopted regulation concerning provision of corporate tax relief for investors, legislative bodies suspended it. Such incentive is currently available only in underdeveloped areas, designated by government. It seems that the Ukrainian government does not have any consistent policy regarding investment.

5.4.3. Capital based incentives

Capital based incentives such as accelerated depreciation and investment/reinvestment allowance are the most popular incentives in the concerned countries.

- Accelerated depreciation -

Accelerated depreciation was more important for attracting FDI in the beginning of the 1990s, when depreciation rate, established by old national laws in transition economies, was much lower in comparison to that applied in the Western

countries. After the respective laws were changed and depreciation rate became similar to the Western standards, accelerated depreciation became less important for attracting investment. Such subsidies are not likely to be actionable, because specificity is hard to be found, within the meaning of Article 2 of the SCM Agreement.

In the Czech Republic the accelerated depreciation is applied only to goods which are part of the selected OECD list. This is related to the promotion of investment in high-tech products and industries. It might be the case that such subsidy could be regarded as specific since, there is discrimination between goods in the list and those that do not belong to it.

- Investment allowance -

Investment allowance is provided in most of the countries, although forms of allowance vary among themselves (Table 7). The differences are found in:
a) the extent of allowance; and b) conditions, set by the national authorities, to be eligible for allowance. This form of incentive, like corporate tax relief, is also directed only to investment into manufacturing, in most cases. Such incentives can hardly be regarded as actionable, if they are not provided under conditions that discriminate certain enterprises or industries.

Only in Lithuania all profits spent on capital investment are exempt from profit tax without any conditions and limitations. The other countries provide investment allowance limited to a certain extent. The amount that may be deducted varies from 6% to 75 % of taxable income in Bulgaria, the Czech Republic, Hungary, or from 20% to 50% of investment costs in Latvia, Poland, Romania and Ukraine. In Slovakia, Russia and Slovenia a certain limited amount of profits is not taxed when it is spent on investment.

Poland and Latvia allow deduction for tax purposes with the respect to the R&D expenditures. Article 8.2 (a) of the SCM Agreement permits subsidization of certain R&D activities raging from 75% to 50%, depending on how close the research is imminent to production. In Latvia all R&D expenses are deductible. This certainly exceeds established limits; therefore, such subsidies might be actionable. In Poland it is allowed to deduct up to 50% of R&D expenses. However, terms of eligibility for such subsidies set in national laws are no so specific nor strict compared with those of the SCM Agreement; thus, status of such subsidies is still disputable.

In Poland the amount that is allowed to deduct from the tax basis varies depending on the purpose of investment, location of investment and other criteria. This incentive is provided under additional conditions, such as export performance, sales revenue and minimum investment amount. Enterprises that invest into production of medical equipment or medicines, R&D, patents and licences, implementation of quality control system or newly established ones are also eligible for certain investment allowance. For the investment made in areas with high unemployment there are set the highest rates of investment allowance.

A certain part of expenditures on investment into machinery and equipment is allowed to deduct from tax basis in Bulgaria, the Czech Republic and Romania. In Romania it is also allowed to deduct all investment in housing expenditures. In Hungary limited investment allowance is available only in special economic zones. In Latvia's special economic zones it is allowed to deduct investment into infrastructure expenses. In Slovenia it is allowed to deduct from the tax base certain amount of wages of new employees. Such incentive seems to be in favor of labor intensive industries. It can not be regarded as non-actionable subsidy because it does not comply

with the provisions of Article 8.2 of SCM Agreement. Instead, since it might cause price depression, it can be considered to be actionable subsidy, if there is specificity.

5.4.4. Deduction of promotional and advertisement costs for tax purposes

Deduction of promotional and advertisement costs for tax purposes is allowed in Bulgaria, Slovakia and Romania. Such incentive, if it is provided to all economic agents, can be regarded as non-actionable subsidy. If this incentive were provided only for enterprises engaged in production, it certainly would contain subsidization of domestic goods, thus causing displacement or impediment of imports, or increase of exports. According to Article 6 of SCM Agreement, that is serious prejudice to the interests of the other countries, and it makes the subsidies actionable.

5.4.5. Possibility to carry forward losses

Usually companies incur losses at the initial stage of investment, especially if they are eligible for various forms of deductions related to investment. Possibility to carry forward losses against future taxable income is provided in most countries in the region. The period is limited to 5 years in most countries, with exception of the Czech Republic where losses can be carried up to seven years. In OECD countries such subsidy is widely used and often the period for carrying forward losses is much longer. However, if such subsidies are specific they may be regarded actionable, since they may contain serious prejudice within the meaning of Article 6.1. (b).

5.5. Other incentives

Competing for investment transition countries offer incentives or packages of incentives other than fiscal and financial ones (Table 8). Large multinational corporations may obtain "negotiated" incentives. Examples of such practices may be import protection imposed in relation with investment into motor vehicle industries in Poland, Romania, Ukraine and the Czech Republic. In Lithuania, investment in telecommunication services has been granted special monopolistic rights, by introducing new regulation. Russian, Bulgarian, Hungarian and Ukrainian laws provide for possibilities to conclude special concession agreements between government authorities and investors. Such agreements may give exclusive rights for maintaining certain monopolistic activities in designated sector. It is difficult to embrace all such cases where the government provides special incentives for a single investor because of the lack of transparency. Such incentives are surely actionable subsidies since there is "specificity" in provision of such subsidies within the meaning of Article 2 of the SCM Agreement.

Some countries (the Czech Republic, Slovenia, Russia and Bulgaria) provide special institutional support, simplified export-import procedures. That is important in countries that maintain complicated administrative regulations, where bureaucratic inefficiencies and red tapes hinder business activities. Such incentives may be problematic in the sense that they may infringe on the most-favored-nation clause, which is GATT Article I, by discriminating certain investors in some cases.

Various forms of incentives might be provided to the so called "priority investment projects" in countries like Bulgaria, Slovakia and Ukraine. Since there is no clear and objective criterion for investment projects to qualify for such status, these incentives may also be specific subsidies.

To promote investment government authorities (in most cases local authorities) provide low priced real estate or land (Bulgaria, Hungary, Slovenia and the Czech Republic). Since it is more than just provision of normal infrastructure, it could be regarded as actionable subsidies.

The most popular types of the other incentives in transition economies is establishment of special districts where investors could maintain their activities. Governments designate special zones within the territory where investors may enjoy more favorable tax regime than other districts in the country, subsidized infrastructure and simplified administrative procedures. All transition economies maintain such zones, though the incentives they provide within these zones vary among them.

There are two types of preferential zones:

a) Free Economic Zones (FEZ) which is designed to accelerate the country's economic growth through the positive spillovers generated by these zones; and

b) Special Economic Zones (SEZ) which is designed to accelerate the economic development of the selected regions.

There is a great variety of investment incentives available in the FEZ (Table 9). The extent of subsidization and conditions for obtaining incentives differ from country to country. In some countries they are related to export performance or use a certain share of local products which allows such subsidies to be considered prohibited. In some countries incentives are unconditional and relatively insignificant. No matter what incentives are provided in the FEZ, the existence of such zones itself make subsidies provided within the zone actionable, considering the provisions of Article 2.2. of the SCM Agreement, "a subsidy which is limited to certain enterprises located within a designated geographical region ... shall be specific".

According to Article 8 of the SCM Agreement, specific subsidies that are provided as assistance to disadvantaged regions are non-actionable if they meet certain conditions. Thus incentives provided in the SEZ may be regarded as non-actionable in case they satisfy certain conditions. Latvian, Polish and Ukrainian laws governing the establishment of the SEZ do not satisfy the strict criteria provided in Article 8. (b). Therefore, subsidies provided in these regions may not be regarded as the non-actionable subsidies. Some of the incentives provided in these zones could be considered as causing adverse effects. Moreover, in Latvia, subsidies provided to the SEZs may be considered as prohibited since provision of incentives is related to export performance. Most incentives provided in zones of both types are fiscal. That is, most popular forms of incentives are corporate tax relief and reduction of other taxes. In all FEZs there are special customs regime; therefore, goods enter such zones without paying customs duties. The existence of such zones seems to be extreme type of competition for foreign direct investment.

As mentioned before, most of the transition economies maintain special programs to support small and medium size enterprises. Typically such enterprises may enjoy more favorable tax regime and easier access to financial resources. There are clear criterion such as the number of employees and revenue, to qualify for status of the small and medium size enterprise. These are objective criteria according to Article 2 of the SCM Agreement, and, therefore, there is no specificity. On the other hand, it is unlikely that such incentives would be used as an instrument competing for investment since the main target of such competition is large multinationals.

Setting less strict environment and labor standards might also be regarded as investment incentive. It is quite likely that some of the poorer countries in the region set such standards low to attract investors. However, such incentives can not be

regarded as a subsidy, within the understanding of Article 1 of the SCM Agreement, since there is no financial contribution by government.

5.6. Summary and conclusion

Transition economies provide a variety of incentives for investors. Although some of them are not Members of the WTO currently, they are pledging themselves to follow the WTO provisions since they are in the process of acceding to it. The SCM Agreement of the WTO could be the effective means of limiting the use of investment incentives, since many of them used currently fall into the category of actionable or prohibited subsidies. Despite high costs of the WTO disputes and scarcity of the qualified human resources of the transition economies they can be challenged by the other Members of the WTO. Therefore, it is needed for those countries to take steps to eliminate their investment incentives prohibited in the WTO system and try not to waste their resources, considering that the incentives may be subject to the countervailing measures by the WTO Members. Even if some of the investment incentives provided in the transition economies do not contradict the WTO Agreements, the presence of such incentives might serve as a pretext for other countries to take measures against imports from the transitional economies. Thus it is to the interests of these countries to coordinate their investment policies.

CHAPTER 6. CONCLUSION

Investment incentives result in decrease of the world's overall welfare due to their distortive effects on resource allocation. These distortions increase when countries

compete for FDI inflow by providing incentives. Competition for investment can be detrimental to the competing countries due to the following reasons:

a) It is almost impossible to measure benefits derived from investment, thus it is not clear whether costs of attracting investment are not too high;
b) Investment incentives do not have significant impact on locational decisions of investors;
c) Competition for investment raises additional costs for countries and decreases effectiveness of incentives;
d) Investment incentives can be subjected to the WTO Remedies and Countervailing Measures.

Although the WTO SCM Agreement may be the effective means of limiting use of investment incentives, it is not designed to prevent distortions in investment flows. The Agreement covers only trade related aspects of incentives. A further improvement in worldwide investment framework might be achieved by establishing integrated multinational rules specially designed for investment that would reflect issues related to both trade and capital flows.

Investment incentives are likely to play a minor role in distribution of FDI among the transition economies. The competition for investment among these relatively small countries may make each of them worse off. As the transition economies are the Members of the WTO currently or taking steps to accede to it they may be challenged by the WTO members, if the investment incentives provided do not conform fully to the WTO provisions or even if their legal framework is disputable. It would be to their own benefit for the policymakers in the transition economies to reconsider their policies on investment in the context of the WTO system and take steps towards elimination of measures inconsistent with the WTO provisions.

The establishment of favourable, overall investment climate is by far more difficult task than provision of numerous investment incentives. Co-operation instead of competition in the region could remove the needless expenses to a certain extent, bring stability and improve welfare of each transition economy.

TABLES

TABLE 1.
FDI flows into transition economies, 1990 - 1998

FDI flow ($m)	1990	1991	1992	1993	1994	1995	1996	1997	1998
Bulgaria	na	56	42	40	105	82	100	497	270
Czech Rep	na	na	100	600	700	2,500	1,400	1,300	2,540
Hungary	300	1,500	1,500	2,300	1,100	4,500	2,000	2,100	1,150
Latvia	na	Na	43	51	155	244	376	515	200
Lithuania	na	Na	25	30	31	72	152	328	950
Poland	89	100	300	600	500	1,100	2,800	3,000	7,500
Romania	18	37	73	97	341	417	263	1,224	884
Russia	na	na	700	400	500	1,700	1,700	3,800	1,100
Slovakia	18	82	130	200	200	200	200	50	350
Slovenia	4	41	113	11	128	176	186	321	301
Ukraine	na	na	200	200	100	400	500	600	700
Total	429	1,816	3,226	4,529	3,860	11,391	9,677	13,735	15,945

Source: Business Central Europe database

na: not available

TABLE 2.

FDI flows into transition economies adjusted by the size of economy

	Cumulative FDI (thousand USD) (As of 1998. 12. 31.)	FDI per capita ($) (As of 1998. 12. 31.)	FDI as per cent of output	
			1995 - 1996	1997 - 1998
Bulgaria	1,269	151	0.80	3.30
Czech Rep	9,140	887	4.50	3.40
Hungary	18,259	1790	7.40	3.50
Latvia	1,475	590	3.90	6.50
Lithuania	1,605	434	1.40	6.90
Poland	24,224	628	3.00	3.50
Romania	3,703	165	1.00	2.90
Russia	10,754	73	0.70	0.50
Slovakia	1,135	210	1.30	1.00
Slovenia	1,311	656	1.00	1.70
Ukraine	2,566	50	0.50	1.50

Source: Own calculations based on Business Central Europe statistical database.

TABLE 3.
Factors influencing investors' decisions

Factor	Rank
Legislation	1
Macro-economic situation	2
Political situation – stability	3
Infrastructure	4 - 6
Availability of resources and supplies	4 – 6
Access to the domestic market	4 – 6
Privatization	7
Access to the regional markets	8 – 9
Development of the sector	8 – 9
Cost advantages	10 – 12
Access to the EU/EFTA	10 – 12
Early presece on the market	10 – 12
Existing business relations	13
Investment incentives (financial and fiscal)	14
Availability of information	15 – 17
Intervention in trade (tariff, NTB, protection)	15 – 17
History of the country	15 – 17

Source: Survey of VVMZ.

TABLE 4.
Investment incentives in the selected countries in transition – Financial incentives

	Bulgaria	Czech Rep.	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovakia	Slovenia	Ukraine
1. Interest subsidy	+		+			+		+			+
2. Preferential credits			+		+			+	+	+	
3. Interest free loans		+	+								
4. Non-repayable grants			+			+		+	+	+	+
5. State guarantees to investment loans			+	+	+	+		+	+		
6. Export guarantees/ insurance at preferential rates		+			+	+					
7. Financial assistance for exporters		+		+						+	
8. Export credits		+	+	+	+	+	+		+	+	
9. Environment protection related grants			+			+					
10. R&D grants			+							+	
11. Job creation grants		+	+						+	+	
12. Job training grants		+							+	+	
13. Grants for construction of infrastructure		+	+			+					

Source: Various websites of national investment agencies and WTO, Trade Policy Reviews.

TABLE 5.
Investment incentives in the selected countries in transition - Fiscal incentives

	Bulgaria	Czech Rep.	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovakia	Slovenia	Ukraine
1. Exemptions from VAT, import duties and fees on imported capital contribut.	+					+	+	+	+	+	+
2. Exemptions from VAT, import duties and fees on imported materials and components	+						+	+	+		
3. Exemption from import duties and/or VAT on certain goods (machinery, technolog. equipment)		+		+	+			+	+		
4. Corporate tax relief / holiday	+	+	+				+	+	+		
5. Exemption from other taxes								+			
6. Accelerated depreciation	+	+	+				+	+	+	+	+
7. Investment/reinvestment allowance			+		+			+	+	+	
8. Special deductions	+	+		+		+	+	+		+	+
9. Deduction for tax purposes promotional and advertisement costs	+						+		+		
10. Possibility to carry forward losses	+	+	+	+	+	+	+	+	+	+	+

Source: Various websites of national investment agencies and WTO, Trade Policy Reviews.

TABLE 6.
Forms of corporate tax relief / holiday

	Bulgaria	Czech Rep.	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovakia	Slovenia	Ukraine
1. Unconditional	S										
2. Related to employment	+		+			S					
3. Related to amount of investment	+	+	+		S	S	+		+		S
4. Related to sales revenue / turnover			+			S			+		
5. Related to exports				S		S			+		
6. For establishing enterprises								+			
7. For investment into manufacturing		+	+			S			+		
8. For investment in designated areas	+	+	+	+	+	+	+	+		+	+

Note: S denotes investment incentives provided only in certain districts within the country.

Source: Various websites of national investment agencies and WTO, Trade Policy Reviews.

Table 7.
Forms of investment allowance

	Bulgaria	Czech Rep.	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovakia	Slovenia	Ukraine
1. Unconditional			S		+			+	+	+[1]	+
2. Cost of machinery or equipment	+	+	S			+[2]	+				
3. R & D expenses				+							
4. New investment, to establish						+[3]					
5. For investment in housing							+	+			
6. For investment into infrastructure			S	S							
7. Related to employment								+		+ S	
8. Related to amount of investment						+					
9. For investment into manufacturing								+			
10. Related to sales revenue						+					
11. Related to exports						+					
12. For investment in selected areas			+	+		+				+	+

Note: S denotes investment incentives provided only in certain districts within the country.

Source: Various websites of national investment agencies and WTO, Trade Policy Reviews.

[1] 20% of investment
[2] Conditional: machinery pertinent to carry specified activities
[3] Conditional: investment makes at least 2 millons of ECU, investment expenses up to 20 %

TABLE 8.
Investment incentives in the selected countries in transition – Other incentives

	Bulgaria	Czech Rep.	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovakia	Slovenia	Ukraine
1. Preferential government contracts	+		+					+			+
2. Provision of low-priced real estate	+	+	+							+	
3. Special institutional support	+									+	
4. Programs to support small and medium size enterprises		+	+	+	+	+		+	+	+	
5. Simplified export/import procedures		+						+		+	
6. Priority investment projects	+								+		+
7. Free economic zones	+	+	+	+	+		+	+	+	+	+
8. Special economic zones (regional development)			+	+		+			+	+	+

Source: Various websites of national investment agencies and WTO, Trade Policy Reviews.

TABLE 9.
Investment incentives provided in the free economic zones and special economic zones

	Bulgaria	Czech Rep.	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovakia	Slovenia	Ukraine
FISCAL INCENTIVES											
1. Exemption from custom duties	F	F		F S	F		F	F	F	F	F
2. Exemption from excise tax	F			F S			F	F	F		
3. Exemption from VAT on goods	F	F		F S	F	S	F	F	F		F
4. Exemption from VAT on services				F S	F						
5. Exemptions from import duties and fees on imported raw materials and components								F	F		S
6. Corporate tax relief				S	F	S	F	F		F S	F S
7. Tax holidays			F S		F	S			F S		S
8. Accelerated depreciation			F	S							
9. Deductions from social security contributions				S							
10. Reduction in other taxes				S				F			
11. Exemption from other taxes					F	S				F	F S
12. Extended period for carrying forward losses				S							
13. Corporate tax relief in relation to job creation			S			S				F S	
FINANCIAL INCENTIVES											
14. Subsidized loans										S	
15. Loan guaranties				S				F			
16. Not repayable grants			F S					F	S		

OTHER INCENTIVES											
17. Subsidized dedicated infrastructure					F						
18. Special institutional support				F	F			F			

Investment incentives provided in:
F - Free economic zones
S - Special economic zones (regional development)

Source: Various websites of national investment agencies and WTO, Trade Policy Reviews.

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