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FDI DETERMINANTS IN SOUTHEAST EUROPEAN COUNTRIES WITH SPECIAL REFERENCE TO TAX INCENTIVES

As Southeast European countries have become much more attractive for foreign investors since 2000, this paper analyses factors that have influenced FDI inflows in these economies. There is a broad consensus that, regardless of the type of FDI, the most important FDI determinants include market size, prospects for market growth, the degree of development of host countries and the progress made in the process of transition, especially progress in institutional development. Still, the specific FDI determinant in SEECs has been the privatization process, especially that of large-scale state assets.
The assessment of the impact of tax incentives on FDI is evolving - showing increasing evidence that tax incentives in their broadest sense could have a significant impact on the pattern of regional FDI. The effects of incentives are likely to be particularly strong in the competition for FDI within regions, when the initial investment decision has been taken and the investor is choosing between alternative locations in a given region. In such circumstances, taxes will start to play an important role, especially corporate income tax. Its tax rate is of crucial importance and will play a major role in attracting investment. Accelerated depreciation and tax credits (allowances) for investment are even more cost efficient and could be seen as a good supplement to the former major factor. Tax holidays should be avoided. Countries should also consider lengthening loss carry forward and withholding taxes on direct dividends.
JEL: F21, F40, H25, H32

1. Introduction

There are many papers that have been written on determinants of FDI in developing and transition countries, but only a few of them have focused on this region and included all SEE countries in the analysis. The reason is unavailability of statistical data on an annual frequency for a longer period of time for all seven SEECs, especially for B&H, SMN and Macedonia.
Since these SEE countries are becoming more attractive for foreign investors, the aim of our paper is to provide an overview of existing empirical research of FDI determinants in transition economies, especially in the Southeast European region, in order to assess the possible impact of tax incentives on FDI inflows.
This paper tests the following hypothesis:

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Although tax incentives are not the major factor influencing the FDI, in circumstances when overall macroeconomic and business environment in the neighbouring countries converge and they have become close substitutes, investment incentives and especially tax incentives in their broadest sense, could have significant impact on the pattern of regional FDI.
Therefore the paper includes analysis of tax incentives for investment in SEEC with regard to their efficiency. It is concentrated primarily on corporate tax incentives and based on the experience with tax incentives and tax competition in CEEC.
The paper is organised as follows: after some introductory remarks, the second section gives an overview of the determinants of foreign direct investment and the third section of the FDI performance in SEE. The last section analyses investment incentives for FDI with special reference to tax incentives in these countries.

2. Review of Literature on the Determinants of Foreign Direct Investment

Although there are many papers that have been written on determinants of FDI in transition countries[3], only a few of them have included all SEE countries in the analysis. Therefore this section gives an overview of the main findings in the literature on FDI determinants in transition countries generally and particularly in SEECs.
Since there is a broad consensus that the host-country characteristics that attract FDI depend primarily on the type of FDI, we shortly interpret the distinction between two types of FDI. There are two different approaches to foreign investment that have been analysed in the literature: horizontal and vertical models of FDIs. A key assumption in the horizontal model is the presence of economies of scale at the level of the firm, which is the source of the advantage of multinational firms over domestic ones. In other words, in the absence of trade costs (or without trade barriers), there would be no reason for multinational production to realize advantage of economies of scale and serve the foreign market through trade. Therefore this horizontal multinational activity could be seen as a "tariff-jumping" strategy (Yeyati et al., p. 5) and will tend to arise among countries with similar factor proportions and across countries of similar sizes. Trade barriers are a fundamental determinant of horizontal FDI, although the definition of trade barriers is not so narrow; they could be seen as policy-related, but also as natural ones (geographic distance, weak traffic infrastructure, slow administrative procedures on border crossings, etc.).
On the other hand, a vertical model of FDI has different empirical implications because it could be expected that this type of FDI takes place between countries

[3] For example Bevan, A. and Estrin, S., 2000, "The determinants of foreign direct investment in transition economies", CEPR Working paper, No. 2638; Resmini, L., 2000, "The determinants of foreign direct investment in the CEECs", Economics of Transition, 8 (3), pp. 665-689.; Babić, A. and Stučka, T., 2001, "Panel analysis of FDI determinants in European transition countries", Privredna kretanja i ekonomska politika, No. 87/01, Zagreb; Grčić, B. and Babić, Z., 2003, "The determinants of FDI: Evaluation of transition countries attractiveness for foreign investors", Fifth International Conference Enterprise in Transition, Faculty of Economics Split, pp. 1166-1176.; Campos, N.F. and Kinoshita, Y., 2003, "Why Does FDI Go Where it Goes ? New Evidence from the Transition Economies", IMF Working Paper 03/228, Washington: IMF; Carstens, K. and Toubal, F., 2003, "Foreign Direct Investment in Central and Eastern European Countries: A Dynamic Panel Analysis", Journal of Comparative Economics, Vol. 32, pp. 3-22. Garibaldi, P., Mora, N., Sahay, R. and Zettelmeyer, J., 2002, "What Moves Capital to Transition Economies", IMF Working Paper 02/64, Washington: IMF

with considerably different factor endowments, or countries that are at different stages of development. In the vertical model of FDI a multinational firm produces the good in a resource-abundant country for both markets and this involves exporting back to the source country. In this case FDI and trade are complements. Besides this narrow definition of vertical FDIs, there is also a broader definition that is related to a strategy of international vertical specialization. (Yeyati et al., p. 8) Different stages of production are located in different countries in order to take advantage of differences in factor prices. Barriers to trade discourage vertical FDI because they increase the transaction costs.

The determinants attracting each type of FDI include market size, prospects for market growth and the degree of development of host countries. These are very important location factors for market-oriented FDI, which prevail in transition countries. The general implication is that host countries with larger market size, faster economic growth and higher degree of economic development will provide more and better opportunities for these industries to exploit their ownership advantages and, therefore, will attract more market-oriented FDI. Even for export-oriented FDI, the market size of host countries is important because larger economies can provide larger economies of scale and spillover effects.

Proximity to the home country has been also proven as an important gravity factor in explaining the volume of trade flows between countries in gravity models.[4] The closer geographical and cultural proximity to the main FDI host countries, the greater the cumulative FDI received. The evidence on effects of labour costs and particularly labour skills on FDI inflows have been found significant and positive. According to Marin (Marin, 2004), Austrian and German firms have been outsourcing many skill-intensive activities into transition countries of Central and Southeastern Europe because of their cheaper skilled labour.

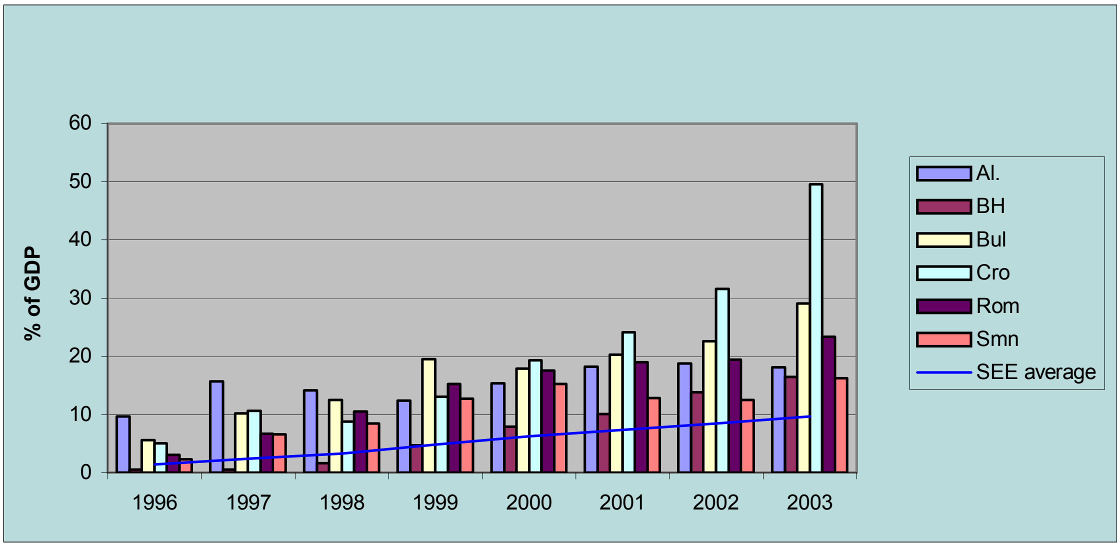
It has been also well documented that the general progress in the process of transition, especially progress in institutional development, represents a very important aggregate determinant of FDI. Particularly important is the development of market-based institutions that provides the rules of the game in a market economy. According to Bevan and Estrin (Bevan and Estrin, 2003), banking sector reform, foreign exchange and trade liberalisation and legal development are closely linked with FDI.

Another variable that seems to be robust and positively related to FDI inflows is infrastructure.[5] The ability to provide better infrastructure services offers important opportunities to reduce costs and increase revenues for the firms. Therefore reform in the infrastructure sector, particularly introduction of the private sector in well-regulated and liberalized environment results in lower prices, better quality of services and thus attract FDI in the region. SEECs have made progress in infrastructure reforms, but in comparison with more advanced CEECs, small countries in Southeastern Europe face significant constraints to infrastructure regulatory reforms that are related to their limited market size and capacity. Therefore the quality of infrastructure, including the availability and closeness to resource-energy sources, represent the important factor that impacts FDI inflows.

[4] See for example: Bevan and Estrin, 2003; EBRD, 2003 and Demekas et al., 2005
[5] See for example: Demekas, et al. 2005, Vlahinić-Dizdarević, N. and Biljan-August, M., 2005.

One of the most important determinant that has influenced the FDI inflows in Southeastern Europe is the process of privatisation. Till now FDI inflows to the SEE region have been largely driven by ticket sales of state assets. The volume and the composition of FDI inflows have been linked mostly to large-scale privatisation transactions in telecommunications, banking and heavy industry. (Broadman et al., 2004, p. 19) The close link between FDI inflows and privatisation process in SEE countries is shown in Figure 1.

Figure 1
Cumulative FDI and Privatisation Revenues Share in SEECs' GDP



Source: authors' own calculations based on EBRD, Transition Report 2004

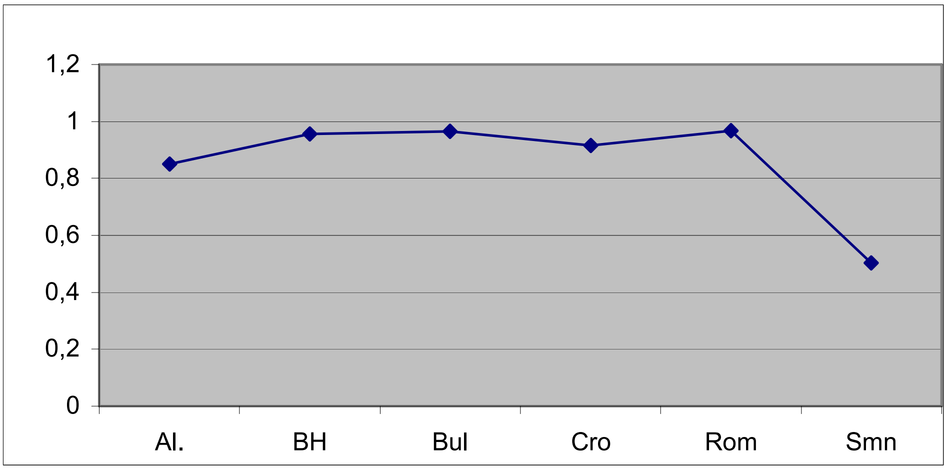
Figure 1 compares two variables: the share of cumulative FDI in the GDP of six SEE countries[6] and the share of cumulative privatisation revenues in the GDP of these countries.

The columns represent the share of FDI in GDP, while the share of privatisation revenues in GDP is calculated as the average for the SEE region. It is obvious that these two parameters have moved in the same direction over time and the correlation coefficient between these two variables is high.

[6] Privatisation revenues data for Macedonia were not available.

Figure 2

Correlation Coefficients between Cumulative Privatisation Revenues and Cumulative FDI Inflows



Source: authors' own calculation

Correlation coefficients for all countries except Serbia and Montenegro are above 0.8, which represent strong relationship between these two parameters. Similar results have been found in the EBRD study (Falcetti et al., 2003), which has compared the annual change in gross FDI inflows and the annual change in privatisation revenues. The degree of co-movement, as measured by the correlation coefficient, is significant and much higher for SEE countries (0.68) than for CEB (0.49).

According to Vlahinić-Dizdarević and Biljan-August (Vlahinić-Dizdarević, N., Biljan-August, M., 2005), the most important determinants that have influenced the choice of FDI destination in Southeastern Europe in the period 1996-2003 are the progress in privatisation. The regression results indicate that progress in transition and economic reform had important impact on FDI inflows in SEECs, especially the progress in small-scale privatisation. Privatisation of more politically sensitive large state-owned enterprises has been much slower and thus its impact on FDI inflows in SEECs is on average positive, but less significant.

Regional integration through Regional Trade Agreements (RTAs) is considered to have a positive impact on FDI inflows, which is a very important consideration for SEECs because of their integration efforts towards the European Union and the establishment of the Free Trade Zone within the region. The question of the impacts of common membership in the same RTA on the FDI flows within the region is primarily an empirical question and depends strongly on the nature of the FDI involved. One could say that FDI between countries tends to be neither purely vertical nor purely horizontal. If trade liberalization makes exporting from one member country relatively more attractive than FDI as a way to serve the regional market, then RTA could cause a reduction in intra-bloc investment. But the liberalization could also enable transnational corporations to operate vertically in a RTA area and therefore stimulate intra-FDI flows among the relevant partners. (Dee, Gali, 2003, p. 23)

Although the effects of different kind of FDIs are different, the general conclusion is that the establishment of RTA in SEE would increase FDI in the region as a whole and it could be an important factor in stimulating production in related industries, increasing productivity and transferring technology. But the welfare effects on the region might not be positive if the RTA worsens the allocation of resources or adds new distortions in the regional market. The redistributive effect is especially relevant in the case when member countries have similar location and ownership advantages. In such a case, the redistribution among region depends greatly on investment incentives.
Today most countries across the world have lowered various entry barriers and opened up new sectors to foreign investment, while an increasing number of host countries provide different forms of investment incentives, especially tax incentives. Still, there are different opinions whether investment incentives are an important determinant of FDI flows or just a costly way to discriminate against local firms[7]. Anyhow, Blomström and Kokko (Blomström, M. and Kokko, A., 2003, p. 6) assume that it is clear that the effects of incentives are likely to be particularly strong in the competition for FDI within regions, when the initial investment decision has been taken and the investor is choosing between alternative locations in a given region. The next section gives an overview of investment incentives in SEE countries.

3. Short Overview of FDI Performance in Southeastern Europe

These countries have become more attractive for foreign investors in the late 90s and FDI inflows in the region have reached almost $7 billion in 2003 (Table 1).

Table 1

FDI Inflows by Host Country, 1996-2004 (in USD million)

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004
Albania	90,1	47,5	45,0	41,2	143,0	207,3	135,0	180,4	426,0
B&H	- 2,0	1,0	55,8	154,1	147,2	130,2	265,4	380,9	497,0
Bulgaria	109,0	504,8	537,3	818,8	1001,5	812,9	904,7	1419,4	2488,0
Croatia	510,8	532,9	932,4	1467,2	1088,7	1561,3	1124,0	1713,0	1076,0
FYR Macedonia	11,2	30,1	127,7	32,7	174,5	441,5	77,8	94,6	151,0
Romania	263,0	1215,0	2031,0	1041,0	1037,0	1157,0	1144,0	1566,0	5174,0
S&MN	0,0	740,0	113,0	112,0	25,0	165,0	475,0	1360,0	966,0
Total SEE	982,1	3071,3	3842,2	3667,0	3616,9	4475,2	4125,9	6714,3	12782,0

Source: UNCTAD, 2005

The low level of FDI inflow in the early period till 1996 could be explained by the high investment risk related to conflicts, poor public governance and other basic risk factors. (Hunya, 2004, p. 3) According to the statistical data, there are two groups of countries that can be differentiated based on the volume and character of FDI inflow. (Hunya, 2002, p. 3) The first group consists of three candidate countries for EU integration – Romania, Bulgaria and Croatia which have growing economies and growing domestic demand, more stable macroeconomic environment and pursue a slow but straightforward privatisation policy. Romania

[7] As will be addressed later, this discrimination is to be criticized not only on equity grounds, but also on efficiency grounds (the incentive is abused in a way that domestic investors disguise themselves as foreign ones).

can be considered as the only SEEC with an important export-oriented foreign manufacturing sector and some of the FDI that started with privatisation has attracted further investment and enlarged the export base. (Hunya, 2004, p. 10) It could be said that Romania, Bulgaria and Croatia are mature FDI receivers with the highest FDI inflows in 2004. The second group consists of countries of the Western Balkans (Albania, B&H, Macedonia and S&MN) that have recently gained more stability, but they have recorded lower rates of economic growth and the process of transition to a market economy is still incomplete.

According to FDI inflow data, the slight fall in 2002 can be explained mostly by the failure to complete some strategic privatisations, although in 2003 in each country of the region the FDI inflows rose, especially in Serbia and Montenegro, Bulgaria and Croatia. In 2004 Croatia, Serbia and Montenegro have recorded a slight fall in FDI inflows. The whole region has reached almost 13 billion USD and according to the Southeast Investment Guide 2006 (Bulgarian Economic Forum, 2006), FDI in the region reach a historic record in 2005 of nearly 20 billion Euro. A total amount of FDI in the region was approximately 60 billion Euro for the period 2001-2005, marking a threefold increase compared to the previous five-year period. This remarkable increase in FDI inflows is mostly due to the finalisation and re-launching of some delayed privatisation deals, more stable macroeconomic and business environment and lower investment risks (Table 2).

Table 2

Country Ratings in October 2005

Country	Moody's	Standard & Poors
Albania	-	-
B&H	B3 (positive)	-
Bulgaria	Ba1 (positive)	BBB (stable)
Croatia	Baa3 (stable)	BBB (stable)
FYRMacedonia	-	-
Romania	Ba1 (positive)	BB+ (positive)
S&MN	-	BB- (stable)

Source: OECD, 2005

Considering some relative indicators, differences among SEE countries are less pronounced. Regarding the inflow in per capita terms, Bulgaria is the most important receiver with USD 321 per capita in 2004. (Table 3)

Table 3

FDI Inflow per Capita, USD

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004
Albania	27	14	13	12	47	67	45	57	136
B&H			18	47	39	31	69	99	129
Bulgaria	13	61	65	100	123	103	115	181	321
Croatia	114	117	207	322	245	352	253	440	242
FYRMacedonia	6	15	64	16	86	217	38	46	74
Romania	12	54	90	46	46	52	52	72	239
S&MN		70	11	13	6	20	57	152	119

Source: UNCTAD, 2005

Although Croatia was the leader till 2003, Bulgaria has become the most important host country regarding per capita FDI inflows. More important inflows not before the late 90s could be explained by the privatisation cycle that has started much later than in Central and Eastern Europe, though the absolute data do not match the extend of privatisation deals in CEECs like Hungary, Poland and the Czech Republic. The relative data, on the other hand, show the high importance of FDI inflows in all Southeastern European countries, measured as a share of GDP. (Table 4)

Table 4

FDI Inflows as Percentage of GDP, 1996-2004

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004
Albania	9,7	15,7	14,1	12,4	15,4	18,2	18,8	18,1	20,2
B&H	0,6	0,5	1,7	4,7	7,9	10,1	13,8	16,4	20,1
Bulgaria	5,6	10,2	12,5	19,5	17,9	20,3	22,6	29,1	31,7
Croatia	5,0	10,6	8,8	13,0	19,3	24,1	31,6	49,6	39,1
FYR Macedonia	1,0	2,0	5,7	6,4	11,4	24,8	24,7	22,1	24,8
Romania	3,1	6,7	10,5	15,3	17,5	19,0	19,4	23,4	25,2
S&MN	2,3	6,6	8,5	12,7	15,3	12,8	12,5	16,2	16,4

Source: UNCTAD, 2005

These data on FDI inflows shares in SEEC's GDP take into account the size of the host economy and indicate the relative importance of the FDI inflows. Since all SEECs could be classified as small economies in economic terms, it is to be expected that the foreign capital would represent the important part of their GDP. Since 2000 Croatia has received the highest proportion of FDI inflows, almost 50% of its GDP in 2003, Bulgaria has received around 30% in the last two years, while the shares of FDI inflows in the GDP of Romania and Macedonia have been higher than 20%.

Regarding the distribution of FDI by economic activities, most of the FDI in SEECs have been concentrated in financial services, telecommunications and trade and manufacturing. Service-related FDI inflows into SEECs and in other transition countries have followed the trend of growth in services worldwide and in the region itself. In most of the SEECs there has been substantial FDI penetration in infrastructure services, especially in banking and telecommunications. Privatisation in the banking sector was carried out in all these countries and foreign banks control the majority of banking assets: from 89 per cent in Croatia to 46 per cent in Albania (UNCTAD, 2004, p. 78). Such high shares of foreign affiliates in all SEECs had some positive impacts, especially in lowering interest rates, increasing competition and the range and quality of products and services available, but did not necessarily stimulate recovery of the local enterprises.

On the other hand, FDI in manufacturing is targeted mainly at the local market of cement, beer, tobacco, soft drinks and steel. Most of the FDI inflows were brown-field, while green-field FDI has been mainly in low-technology and labour-intensive industries such as leather, textiles and clothing. Green-field investments in SEECs have been very limited and directed primarily at servicing the domestic market. (Broadman et al., 2004, p. 19)

As to the distribution of FDI by investing countries, EU members have increased their share over the past few years and they are the most important investors in most SEECs. According to the data, the EU-15 is the biggest investor in Albania, Croatia, Bulgaria and Romania, while the share of investors from other countries is especially high in Serbia and Montenegro and Macedonia. The importance of intra-regional FDI flows is evident for Bosnia and Herzegovina (21%) and less for Serbia and Montenegro (9%), mostly these are investments from Croatia.

Of course, the FDIs are not a panacea for all economic problems of transition countries and it has become obvious that there are some negative effects of high FDI inflows, especially current account deficits due to increased imports, which cumulated into indebtedness. The small size of the host countries in Southeastern Europe and the concentration of FDI in trade and finance could weaken productivity spillovers, while the increased efficiency of the acquired firm could be more than offset by the reduction of economic links with local firms. FDI could also force small emerging local competitors out of business.

4. Investment Incentives in SEECs, with Emphasis on Tax Incentives

In this last section, the position of tax incentives in relation to other investment incentives is first briefly presented and later their concept is defined. After that, we discuss the relevance of tax system for the FDI and then compare relevant elements of corporate income tax system for the FDI in SEE and assess their efficiency.

4.1. Investment Incentives

There are a variety of forms of investment incentives, but their usual classification is “direct” (financial) and “indirect” (fiscal) incentives (for instance Easson, 2001, p. 366; OECD, 2003, p. 39).[8] The most important financial incentives are grants, preferential loans or loan guarantees on preferred terms. The host government may also partly cover the initial costs (infrastructure, buildings). Fiscal incentives are different forms of tax reductions.

In contrast to developed countries that tend to rely on both incentives, developing countries, due to the revenue constraints, offer mostly tax incentives. Unlike grants or preferential loans, tax incentives are most suitable, because they impose no immediate costs of relatively little immediate costs.

The abovementioned disadvantage of financial incentives is sometimes seen as the advantage. The costs of the financial incentives are known immediately and the costs of tax incentives are sometimes difficult to estimate. That is the additional argument raised by the proponents of financial incentives, who claim that these incentives are more transparent. But this is not automatically true. Financial incentives could also be non-transparent (for instance infrastructure development by host country) and tax incentives even more transparent (for instance investment tax credit). Even the costs of tax incentives may be lower than the costs of financial incentives, since most tax incentives are linked with the profit and financial ones could be given also to unsuccessful investors.

[8] Besides these major groups, which are both monetary measures, there also exist the so-called “rule-based” incentives (relaxation of the normal residence permit or work permit rules, of possible restrictions on capital transfers, or minimum pay and work protection legislation).

So, the tax incentives could be preferable for SEE, but their rules should be transparent and costs as properly estimated and established as possible.

4.2. Tax Incentives for Investment and Their Relevance for FDI

The term “tax incentives (for investment)” is not straightforward. One may understand it in its completely narrow sense – as “investment incentives” inside the tax field (for instance McLure, 1999) there are classified the incentives that are offered directly in connection with the investment and with the use of classic forms of tax reliefs: tax allowances and tax credits for investments. The former are deductions from the tax base (corporate income-profit) and the latter deductions from tax due. Both are expressed as a percentage of a qualified investment. Accelerated depreciation could be classified in this group, too (even with the declining balance method could be regarded as some form of it).

The extension of this term means inclusion of all the measures that reduce the tax that would otherwise be payable (and are, of course, directly or indirectly related to investment). So, tax holidays (temporary profit tax exemption or lower corporate income tax rate for new companies) including other (temporary) profit exemption or lower corporate income rates related to significant investments in existing companies, as well as other lower rates, exemptions and even reinvestment incentives classify as tax incentives. The accent here is on all departures (in the sense of preferences) from the existing tax systems (lowering the tax burden relative to effective tax burden that would be borne by the investors in the absence of these provisions (for instance Zee, Stotsky and Ley, 2002, p. 14). These departures are more or less targeted, so one could distinguish between special incentives (targeted) that refer only to the certain types of investment and general measures of the tax system, that refer to all investments. Targeting could be done on a narrower or broader basis – by type of investor (domestic-foreign, new-existing), scale of investment (large-small), type of business activity (for instance R&D) or sector, type of production factors, region, market, source of finance.[9]

But, even the general provisions of the corporate tax system, such as general corporate income tax rate, general depreciation scheme, treatment of loss and withholding tax rates on remittances to the home country that are favorable in comparison with other countries (capital importing countries – home countries as well as other countries - possible candidates for location decision – mostly countries in the same region) could be regarded as tax incentives (Mintz and Tsiopoulos underline especially the low statutory tax rate – above the global level (1995, p. 465-469))[10]. Needless to say their improper setting could divert investments from the country and they play an even more important role than the abovementioned “special” incentives. So, further analysis will include them too.[11]

[9] Such a targeting is often criticized on equity and efficiency grounds.

[10] In the time this article was written (1995) it was between 35 and 40 percent; now 35% is the upper limit for instance for the EU and 30% could be regarded as average.

[11] Although investment may be influenced also by some other taxes (VAT, customs and import duties, personal income tax, social security contributions, property tax) their importance is based on the tax shifting effects and is in general considered to be smaller than that of corporate income tax. So, analysis will focus on that tax.

Before starting to analyze the different elements of the tax system, the question could be raised whether taxes matter at all concerning the investment decision in general and in particular for SEE. Before answering that question, it must be admitted, that econometric analysis as well as the surveys of international investors confirm that tax factors are not the most influential factors for multinationals in deciding about the location of their investment[12] (for instance Shah, 1995, p. 25; OECD, 2003, pp. 32-35; Morisset, 2003, p.1). Other factors such as institutional setting, basic infrastructure, political stability, macroeconomic stability and labor costs and availability are much more important. Nevertheless, although most earlier studies (before the 1990s) found out that taxes play a minor role in FDI decision (for the synthesis see OECD, 2001a, p.49-54; OECD, 2003, p. 34), recent studies (after the 1990s) confirm that taxes (corporate income rates and incentives) are becoming increasingly important (OECD, 2001, p. 55-60; OECD, 2003, p. 34; de Mooj, Ederveen, 2003). The trend of increasing and strengthening tax incentives in the world, especially in transition countries, since the early-mid nineties confirms that, too (Morisset, 2003, p. 1; Easson, 1998, p.194-196). The reasons are relatively simple. It is known from literature even earlier that when possible savings/investment instruments/forms are close substitutes, taxes matter more (OECD, 1994, p. 46). Following that logic, the same conclusion could have been drawn about the different investment geographical locations (Blažić, Pečarić, 2001). So, thanks to globalization and regional integrations other barriers for FDI decrease, countries as investment locations become more similar and production highly mobile and internationally diversified. In recent years there has been growing evidence that tax rates and incentives influence the location decision of companies within regional economic groupings (Morisset, 2003, p.1).

The creation of common markets, customs unions and free trade areas had the effect of reducing even other differences between member countries and making the distinction between horizontal (market-oriented) and vertical (export-oriented) incentives, which are especially sensible to tax differences, less clear.[13]

Taking into consideration the above statements, no wonder the interview survey conducted in 2001 among SEE investors (OECD, 2003, p. 34) found very limited evidence of host country taxation being a relevant factor in attracting investment,

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[12] In effect, they have almost no influence on the initial decision of multinationals to invest abroad and a little bigger, but not crucial influence in location decision.

[13] To be completely precise concerning the effect of corporate income tax (and withholding taxes) on FDI, one must mention the often posed objections (based on “traditional” tax considerations) that additional corporate income taxation in the home (residence) country could neutralize the favourable tax treatment of host (source) country and so make host (source) country taxation irrelevant for the final tax burden and as a factor influencing FDI. Namely, most countries apply unilaterally as well as bilaterally the tax credit method in eliminating international double taxation (host country taxes are credited against the final corporate income tax burden, that is calculated according to tax rules of the home country). Nevertheless, the source (host) country taxation is not only relevant, but it also gains in importance due to the number of situations and reasons: if the profits of foreign subsidiaries are retained (and not remitted) they are generally taxed only in the host country, if the host country taxation is higher than the home one (excess foreign tax credit position) there is no additional taxation in the home country and the host country tax burden is relevant, where there is a possibility of mixing high and low-tax income, excess foreign tax credits earned on high-tax foreign income may be used to eliminate home country tax on low-tax foreign income, the home country may provide exemption instead of tax credit which makes host taxes exclusively relevant, multinationals increasingly use offshore holding companies (as financial intermediaries) situated in tax heavens. As already stated, this relevance is confirmed by empirical research.

given the considerable uncertainties and risks posed by investing in the region. Furthermore, FDI in the SEE countries has been primarily privatization-led (with low acquisition costs being the primary determinant) and, in most cases, market oriented (horizontal) as opposed to export oriented. As just pointed out, this type of investment is less likely to be influenced by corporate income tax incentives. This suggests that different tax privileges given were a windfall gain for existing investors.[14]

Following the experience of other (transition) countries, it is completely expectable, that putting the PTAs into effect will not only have positive influence of FDI, but will also make taxes, especially corporate income tax, much more important, not only for extra-regional, but also for intra-regional investments.

4.3. Comparative Analysis of Investment Related Tax Provisions in the SEE

As explained above, the analysis that includes only tax incentives in the sense of selectiveness and targeting is far away from being enough to assess the effects of the corporate income tax system in attracting FDI. The already mentioned logic explaining the importance of non-tax factors in comparison with tax factors, could be repeated for the relationship of tax incentives and other (more fundamental elements) of the tax system such as corporate income tax rate, the tax base - especially depreciation allowances, loss carry over provisions and withholding taxes on direct dividends[15]. If these elements are not favorable or at least not set in the usual way and at the usual level according to international norms, special tax incentives can not compensate for their negative effect on the FDI (and domestic investments).

Table 5 presents the main elements of the corporate income tax system relevant for the analysis. Although the experience of other countries in the world, especially the CEE, but also the SEE countries, can not give the ultimate answer concerning the effectiveness and efficiency of tax incentives and other provisions of the tax systems (because of the evidence being mixed and influenced by other factors), some conclusion could be drawn.

[14] Croatia, which was the country that has been most successful in attracting FDI in the region, provided (until 2001) almost no special (targeted) tax incentives, but a very generous general investment incentive in the form of equity allowance (ACE tax – interest adjusted profit tax). But its relative success in attracting FDI (compared to other countries of the region) is believed to be influenced more by its geographical position and its relatively advanced economy than to tax incentives.

[15] The EU survey (conducted by the famous Ruding Committee) found that 57% of the managers of multinational corporations always regarded the statutory corporate tax rate to be relevant for the location decision. The proportion rises to 80% when managers of multinational corporations who usually take statutory corporate income tax rates are included. Next in importance were withholding tax rates (40%), depreciation rules (36%) and loss relief (35%) (EC Commission, 1992, p. 115).

Table 5

Tax Rates and Corporate Income Tax Incentives for Investments in SEE in 2005

Country	Corporate tax rate (%)	Tax holidays, lower corporate tax rates and exemptions	Accelerated depreciation[1]	Loss carry over: forward	Tax allowances (TA)[2], Tax credits(TC)[2]	Withholding tax rates (%) on direct dividends: unilateral/tax treaties
Albania	23 *(20 from 2006)*		Immediate write-off possible for assets other than buildings, structures and non-tangibles (having the SL method) if the value of the entire "pool" is under the ceiling specified	3 years		10 / mostly 5, sometimes also 10
Bulgaria	15	Agriculture: only 40% of income from unprocessed plant and animal production is subject to tax Commercial shopping companies: tonnage tax: tax levied on the net tonnage of vessels		5 years	Regional: TC (10%) in municipalities with high unemployment (100% for production companies)	7 / sometimes 5, no withholding tax for EU
Bosnia and Herzegovina	30	3 years: 1st year-100% exemption, 2nd year- 70% ex., 3rd y.–30% exemption Free zones: 5 years FDI (min. 20% foreign share) – 5 years lower tax according to the foreign share in entire equity 100% exemption for profits reinvested in own production and 75% exemption for profits reinvested in other own activities	Higher rates (25% and 50% higher) for work in 2 or 3 shifts Higher rates (25% higher) for fixed assets that prevent pollution, assets for R&D and education and computer equipment	5 years		n.a.

Croatia	20	10 years (full exemption or lower rate (10%,7%,3%) depending on the amount invested (in effect only for large investments) and number of employees Regional: Vukovar area (most affected war area): 10 year exemption Regional: War affected and underdeveloped areas (3 groups according to the level of war affectedness): 10 years exemption for the first group (25% and 75% of the general tax rate for the second/third group) Regional: Mountain areas: 75% of the tax rate (no time limit) Free zones: 50% of corporate income exempt; for investment above the ceiling full exemption for up to 5 years, but may not exceed the amount of the investment Exemption for R&D companies	Official SL rates could be doubled (time halved).	5 years	TA (100%) for R&D	No withholding tax
Macedonia	15	3 years starting from the year when profit is earned (if min. 20% foreign capital) 3 years for companies listed on stock exchange (50% reduction) 10 years for free-trade zones 1 year (50% tax reduction) in the first year when profit is realized	Yes, but prior approval of the tax authorities must be obtained if the total of depreciation allowances would exceed by more than 10% the depreciation computed under the SL method. For investments in modern technology and environmental protection: general rates of depreciation increased by a maximum of 25% (prior approval from the tax authorities must be obtained)	3 years[3]	TA for profits invested in environmental protection TA for investments (without cars and furniture) up to yearly limit and for the 30% of inv. value exceeding the limit, unlimited carry forward TA (50%) for profits invested in undeveloped regions	No withholding taxes on all payments to non-resident companies

Romania	16	Different activities in free trade zones exempt. 3% tax rate for small companies	By applying a coefficient between 1.5 and 2.5 to the SL rates Technological equipment and patents up to 50% of the acquisition costs in the first year Taxpayers that did not benefit from the accelerated depreciation or other incentives are entitled to deduct 20% of the acquisition cost of depreciable fixed assets and patents (expired in April 2005) Immediate write off for investments made to prevent work accidents or to set up medical units Accelerated depreciation for investment above the min. value that promote econ. development and new jobs	5 years	TC (20%) for investment above the min. value that promote economic development and new jobs	15 / mostly 10, but also 15 or 5

Serbia and Montenegro	Serbia:10 MN: 9	Serbia: 10 y. (starting from the first year in which they realize taxable income), min. investment as well as number of employees required. The proportion of tax exemption is set as the ratio between investment in fixed assets and the total fixed assets. MN: 3 y. for new production companies in undeveloped areas Companies deriving income through a newly established branch in an undeveloped area are granted a tax credit equal to the proportion of the branch income to the total income for 2 years (3 years in MN). Enterprises engaged in activities subject to a concession: exemption up to 5 years	DB Only in Serbia: normal rates increased by up to 25% for assets used for environmental protection, scientific research and education, as well as for computer equipment	Serbia:10 years MN: 5 years	TC: 20% for fixed assets (except cars, furniture, carpets and art objects). The credit may not exceed 50% of the tax due. Any excess may be carried forward for 10 years. TC: 80% for agriculture, fishing, textile industry, metal industry, the production of machines, communication equipment, medical equipment, vehicles, recycling activities or cinematographic production; no limitation in respect of the tax liability	20 (MN:15) / mostly 5, but also 10 and 15

[1]SL–straight line, DB-declining balance

[2] Percentages (mostly in parenthesis) referring to TA or TC denote percentage of value of investment for which TA or TC is given; if TA or TC relate to the income (and not investment value) this is specified explicitly

[3] But a prior approval of the tax authorities is required; no carry forward in the case of reorganizations

Source: IBFD: European Tax Handbook, 2005; http://www.nn.hr: Croatian Profit Tax Act (2004); http://www.fbihvlada.gov.ba (for Bosnian Profit Tax Act)

Although non-tax experts first take a look at the statutory corporate income tax rate, neglecting other elements of the tax system, which is often criticized, it must be admitted that this rate is the most important tax parameter (see previous footnote). This was confirmed in the already mentioned survey for SEE investors – where tax provisions were taken into account, the corporate income tax rate was typically the key tax factor.[16] The attractive factors are numerous: transparency, simplicity, low compliance costs in respect of other incentives, the absence of tax planning opportunities and neutrality. Selective (targeted) tax incentives are often criticized, not only by academics, but also by international institutions and associations (IMF, OECD, EU, WB) for their discrimination, distortion and non-neutrality, influencing investors' decisions in a way that the choice of investment is driven by tax parameters and not their profitability. EU (as well as OECDs) measures against "harmful tax competition" as well as "state aid" explicitly exclude low general statutory tax rate. Taking all the above into consideration, it is no wonder that we witness maybe the strongest "race to the bottom" trend (lowering statutory corporate tax rates) in tax history. This is especially true of the transition countries, so, for instance, the average corporate tax rate of new EU members (around 20%) is around 10 percentage points below the average for old EU members (around 30%). The statutory corporate income tax rates in SEE experienced that trend, too, are already relatively low. They seem to be attractive and there seems to be little to gain from further reduction (OECD, 2003, p. 190).[17] Although this could be said about the region in general, there are huge discrepancies in the tax rate (from 9 to even 30 percent). Bosnia and Herzegovina is already planning to reduce its highest rate in the region and although changes were announced for 2005, they are still not realized. Even Albania and Macedonia should be concerned. Serbia and Macedonia seem to be most attractive concerning this criterion alone.[18] Croatia will probably have to consider further reduction in the future (see footnote 12).

Unlike low tax rates, tax holidays seem to be mostly criticized, although also a very often used incentive. Although they are the most generous immediate allowance for green-field investments[19], their costs (revenue loss for the host country) are not linked directly to the investment value and so can not be precisely estimated and limited. Their biggest disadvantage is that they are most open to abuse (tax planning opportunities). For instance, when the holiday expires companies close down and then restart in another location (mostly footloose industries) – the harm is even done if that is the same country, since the holiday is misused - used twice, with the corresponding higher revenue loss. Multinationals can shift taxable income from other companies into the company enjoying the holiday (transfer pricing, thin

[16] Of course, the attractiveness of this element presumes a tax base consistent with international norms.
[17] Of course, it is hard to predict whether, or better how strongly, will the "race to the bottom" continue in the future.
[18] Some possible disadvantages of a very low general statutory corporate income tax rate, which could serve as an argument not to reduce it tremendously further, will be mentioned later (in comparison with other tax incentives).
[19] The problem for investors could arise when tax holidays are short and during the first year(s) investors do not earn profit at all. This could be mitigated/avoided by starting the holiday from the first year when profit is earned, enabling the carry over of unused depreciation and other deductible expenses and/or lengthening the time period. That in turn makes revenue loss for the host country higher.

capitalization and other financing and tax arbitrage techniques) not only between countries, but also inside the country offering the tax holiday. The latter can further reduce revenue loss tremendously (without any rise in investments) and the former benefits investors in other countries.[20] So, holidays are often less likely to attract industries bringing more significant capital commitment. Because they benefit new enterprises instead of new investments they are not only unfair, but, as previously shown, inefficient. There are attempts to avoid some of the given disadvantages by linking tax holidays to significant investment amounts and number of employees as well as lengthening their period (Croatia, Serbia).

In order to avoid discrimination of existing companies, a lot of SEE countries feature lower rates or exemptions for existing companies (mostly on a permanent basis). So, they still retain other drawbacks of tax holidays. Sometimes the tax saving on temporary relief is limited to the amount of investment (as is the case in Croatia).

It is very often that tax holidays (or exemption and lower rates) are targeted by location (free zones, undeveloped regions). This is also the case with the SEE countries (Croatia, Romania, Macedonia and Bosnia and Herzegovina). Special "zones" could have been more justified in the earlier years when these countries had relatively undeveloped market economy (or maybe still are due for that reason). With the development of these countries and especially with the further development in the direction of a common market, it is hard to justify that special incentives are constrained only to a specific "zone". Special "zones" tend to attract highly mobile activities and not capital-intensive long-term activities[21] and they largely cause capital to be diverted from elsewhere in the country. Still, the tax incentives for undeveloped regions, like for the war affected areas in Croatia, could be seen as part of the regional development policy, with the reason to make up for the regional disadvantages. Although they are more justified, there is still the question whether they would be enough to compensate for the negative factors (so the revenue loss is too high in comparison with the additional investment achieved), but for the short run, they are almost the only instrument available.

Still some SEE countries (Bosnia and Herzegovina, Macedonia) target tax incentives directly to foreign investors. In general, that belongs mostly to the early stage of the development of tax systems of transition countries (Erdös, 1993, p. 214; Easson, 1998, p. 193; IBFD, 1999, p. 15-31).

Even former Yugoslavia used such form of incentives at the end of the eighties (only half of statutory corporate tax rate for profits from foreign investments). Even at that time it was shown how easy this could be abused (by routing domestic capital via a foreign country – for instance through offshore holding companies back to the source country). Furthermore, this is also discriminating and may lower the already low tax morale and compliance in SEE countries.

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[20] A similar effect could be achieved with a lower general corporate income tax rate, with the result of increasing corporate income tax revenues of the country offering a lower rate and being one of the additional reasons in favour of the lower tax rate (however, this benefit is achieved directly "at the expense" of the other countries where the multinational corporation operates). The same is true of the tax holiday in the form of the reduced tax rate, depending on the departure of the rate from the general rate and the scope of targeting of the holiday.

[21] There are attempts to avoid this in Croatia, by linking the full exemption to the investment amount (which also represents the upper limit for the tax saving in order to limit the revenue loss).

Bosnia and Herzegovina offers one more old-fashioned tax incentive, which was relatively often seen in other transition countries earlier (OECD, 1995; IBFD, 1999, pp. 15-31) – the exemption of reinvested capital. Such a targeting is claimed to be completely wrong (OECD, 1995; OECD, 2003, p. 197 and 199). It discriminates against other forms of financing. The retained earnings are the most common source of finance, generally cheaper than debt or new share issues and supporting them additionally is not justified. If investments should be promoted, that should be done for investments in general and the incentive should be tied to the amount of expenditures.

The third group of tax incentives for investment are investment incentives in the narrower sense such as accelerated depreciation (with the immediate write off – immediate expensing at its radical form), tax allowances and tax credits. They are among the best ranked tax incentives.

As already stated, no tax incentives can make up for the basic drawback of the impropriate tax base. One of the main factors that inhibited investments in the earlier phase of transition countries were inappropriate depreciation schemes, which were complicated and had too low rates (OECD, 1995). Although they are now mostly in accordance with international standards, another boost for investment could be made through accelerated depreciation or at least the declining balance method (Serbia)[22]. Due to the relative simplicity possible and direct link with investment without revenue loss (only time shifting) for the government and the benefit for investors (increase of present value of depreciation allowances)[23] - it is no wonder almost all SEE countries offer some form of accelerated depreciation[24]. It can be as general (neutral) as possible (Croatia, Macedonia, Romania). Where targeting is present, it is typical to offer it for "more productive and "merit" investments" such as environmental investments, high technology, R&D, education, computers or equipment in general (Croatia before 2005, Serbia, Romania, Bosnia and Herzegovina).

Such targeting is even accepted in developing countries, where the prevailing logic is that depreciation above the true economic one (whatever this one could be) is inappropriate. Immediate write-off, although rare, is also relatively more frequent in the SEE.[25]

One of the greatest advantages of accelerated depreciation as well as tax credits and tax allowances for investments is the fact that they target incentive for the new investment, rather than new enterprises (tax holiday) or the existing investments (general or specific lower tax rate). In that way discrimination against existing enterprises is avoided, but also the revenue loss, related to relief for old (existing) investments. The value of the revenue loss (tax saving) is tied to the value of

[22] Although the declining balance is very often used in developed countries, it is rarely used in SEE countries, probably due to its complexity relative to the SL method. Increased reliance on the declining balance could be recommended for other SEE countries (OECD, 2003, p.191).

[23] Its other advantage when compared to tax credit (see below) is not only that it does not create additional revenue losses, but also does not favour fixed over current assets and investors are not inclined to sell and repurchase assets in order to use tax credit (or tax allowance) repeatedly.

[24] In order to benefit all the investors (even those who have relatively small profits or are suffering a loss) it is crucial that higher allowances are elective and/or losses can be carried forward in full.

[25] Its abolishment in 2005 in Croatia, in spite of the relatively successful implementation, was caused by the lack of special accounting - and tax balance sheet and income statement, which caused accounting unacceptable and unreal - zero values of fixed assets in the balance sheet.

investment and can be specifically established and estimated as well as targeted[26] and limited. Furthermore, such up-front incentives give immediate and sure tax saving[27]. The more unstable the tax systems and the entire macroeconomic and political environment are, the less sure are future tax savings under some other arrangements with infinite time horizon[28] and more attractive are up-front incentives[29]. Needless to say that this applies completely to SEE,[30] so these incentives are also present here. They are narrowly targeted (regional – Bulgaria, Macedonia; for different industries – Serbia; environmental protection – Macedonia) or broadly targeted (Serbia and Montenegro, Romania, Macedonia). The Croatian 100% tax allowance is not only investment allowance, since it includes all the R&D expenses.[31] One of the possible problems of tax credits (allowances) being lost, because of the low tax/tax base is solved in Serbia in a prescribed way in the world (10 years carry forward).

Loss relief is also one of the fundamental requirements of the tax system then the real "relief". To be fully consistent with tax principles, only unlimited loss carry over is adequate. Still, international norms provide a minimum of five to seven years of carry-forward, but a lot of developed countries offer more (some of them even unlimited carry-forward) as well as carry back.

Here, the SEE countries lag behind in general, with the exception of Serbia which offers even 10 years carry-forward. Macedonia and Albania are under the international minimum, meaning that they should urgently consider raising the limit to at least 5 years. In addition, Macedonia makes this carry over discretionary (see the note 3 under the Table 4), which is the additional drawback.

As the source (host) country gains in importance, withholding taxes in general, especially on direct dividends repatriated to parent companies in home countries, seem to gain in importance for FDI. Although most countries negotiate favorable 5% in bilateral treaties with their main partners, Macedonia and since 2005 even Croatia decided to be even more generous (abolished the withholding of tax on dividends). This was strongly criticized in Croatia (for instance Spajić, 2004) for being windfall loss for the host country and windfall gain for the home country (based on the assumed foreign income tax credit method in home countries) and so having no effect on the tax burden of investments. But taking into consideration that almost 50% of FDI in Croatia come from Austria and Germany (Banka Magazine, p. 2), both of which offer exemption of foreign dividends, as well as the

[26] Even further investment incentive with less revenue loss (more precise targeting) could be achieved through "incremental" investment tax credits – tax credits for the new investments above the usual yearly level of new investments. But this seems to be too hard to administer for SEE.

[27] In the scope of depreciation allowances this is mostly true for immediate expensing.

[28] Croatia is a typical example. Since 1994 it has started to offer the so-called "protective interest" (allowance for corporate equity), which in effect meant exemption for profits of up to 5% of the company's own capital invested (calculated as corporate equity at the beginning of the year). When this general tax incentive was replaced by a lower tax rate (from 35% to 20%) in the 2001 the real "losers" were capital-intensive industries. They had based their long-run profitability on the calculations that had included protective interest.

[29] For other advantages of these tax incentives see also: McLure, 1999, p.331-332.

[30] The drawbacks of tax credits and tax allowances for investments are already mentioned in footnote 18.

[31] Which can be regarded as investment in a broader sense.

fact that EU countries have abolished withholding tax for direct dividends inside the EU (Parent-Subsidiary Directive), this decision turns out to be more sensible.[32]

On the other hand, if we look at the SEE countries from the point of view of intra-regional investments as capital exporters, the tax systems of Croatia (dividend exemption), Serbia (direct and indirect tax credit for foreign source dividends) and Montenegro (dividend exemption) seem to be most favorable for the possible investors from that country into other countries in the region.

There is no consensus on the best form of positively influencing FDI (and incentives in general). While some advocate up-front incentives (Shah, 1995; Boadway, Shah, 1995; Mintz and Tsiopoulos, 1995) it seems that the majority, especially international institutions, advocate general low statutory corporate income tax rates (OECD, 1995, 2001, 2003; Genser, 1999; Morriset, 2003, but also Shah, 1995). Although up-front incentives are suggested by basic logic and economic theory to be the most efficient, their revenue loss can not be compensated by the relatively higher tax rate of the host countries involved. Namely the tax planning opportunities (tax arbitrage) causes multinationals to shift the tax base to the countries with lower rates.[33]

So, the low corporate tax rate is a “must” for SEE countries for attracting FDI as already underlined.

If additional tax incentives should be provided, they should be mostly given through the investment tax credit (allowance) and accelerated depreciation, but they can not make up for the advantage of the low tax rate. Even some of them and especially some other investment incentives depending of their selectiveness could be phased out during the SEE accession to the EU.[34]

In the end, it is important to underline that besides and above the stated factors analyzed, transparency, predictability, low compliance costs and non-discretion are the crucial important elements of the tax systems that accompany the relatively low tax rate and tax base according to international rules. Where tax was identified

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[32] Still, maybe the exemption could only be given to direct dividends and not to all dividends. On the other hand, tax evasion of foreign income is especially profound for individual investors, who are portfolio investors, making source country taxation extremely relevant. This confirms also the lowering and abolishment of withholding taxes on the interest of non-residents on bank savings, corporate and government bonds (OECD, 1994, p. 177).

[33] Fine transfer pricing, this capitalization, CFC and other rules should not only be build into the tax low, but also effectively realized in order to avoid it, which is demanding even for the developed let alone SEE countries.

[34] Not only The Code of Conduct with its rules concerning “harmful tax competition” is important, but even more “state aid” definition, which encompasses also tax breaks, that are recognized to have effects equivalent to cash subsidies. “State aid” are all measures that are not “general”. Measures are considered general when there is no specificity in terms of sector, region or category; the eligibility for the aid is based on objective criteria, without any discretionary power of the authorities; and the measure is in principle not limited in time or by a predetermined budget. So, tax holidays seem to be more jeopardized, but also are other selective measures. Some exemptions may be given for regional development, but such aid must be consistent with EU regional policy and be proportionate to the aim pursued. Otherwise, practically any provision that influences the choice of business location within the EU (that means in effect all tax incentives) is reviewable.

It is interesting to point out that Romania’s and Macedonia’s Agreements with the EU provide that the entire territories of the non-EU party are to be considered less-developed regions, with the consequence that aids are permissible (but of course must be in accordance with the EU regional policy) (OECD, 2003, p. 949). For more information about tax changes in the newest EU members see: IBFD, 2004a.

as an important factor in the already mentioned SEE survey (OECD, 2003, p. 34) the relevant concerns were transparency and complexity, rather than particular tax relieving provisions.

5. Concluding remarks

The existing empirical research on FDI determinants is based on the distinction between two types of FDI: horizontal and vertical. Although it is usually believed that the horizontal FDI is predominant in transition countries, it has been concluded that the determinants attracting each type of FDI include gravity factors like market size and proximity to the investing country, prospects for market growth and the degree of development of host countries. It has also been well documented that the general progress in the process of transition, especially progress in institutional development, represents a very important aggregate determinant of FDI. Particularly important is the development of market-based institutions that provides the rules of the game in a market economy. Still, the most important determinant in explaining FDI inflows in SEECs so far has been the privatization process. The analysis shows the strong relationship between cumulative privatisation revenues and cumulative FDI inflows with correlation coefficients above 0.8 for all countries except Serbia and Montenegro.

Assuming that the overall macroeconomic and business environment converge, which means that the region in general achieves a relatively acceptable level of development to be attractive for FDI, countries in the region become close substitutes concerning the location of investment. In such a situation, taxes start to play an important role. Due to the globalisation and internationalisation of trade the importance of taxes increase, that of the corporate income tax being predominant. Before starting to analyze special provisions of the tax system of SEE, it must be underlined that their transparency and mostly stability and predictability are still a problem.

Among the provisions of the tax system the basic element, such as the corporate income tax rate, is of crucial importance and will play a major role in attracting investment. Accelerated depreciation and tax credits (allowances) for investment are even more cost efficient and could be seen as a good supplement of the former major factor. Tax holidays should be avoided. Countries should also consider lengthening loss carry forward and lowering withholding taxes on direct dividends.

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