# A Regional Investment Agenda for the Western Balkans (WB6): avoiding a race to the bottom?

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# Outline

1. Overview of investment reform agenda
2. Investment incentives
3. Economic performance of SEZ-related FDI in WB6
4. FDI invectives, SEZs and the local economy
5. Conclusions and policy recommendations

# WB6 Investment reform agenda

- Investment is the major component of the Berlin Process expected to have a major impact on promotion of intern-regional investment and attract FDI into WB6.
- The regional investment reform agenda will ensure:
  - transparent and fair competition among the economies by mitigating a “race to the bottom” whilst not hindering the interests of the WB6 economies.
  - The ultimate goal of the agenda is to improve the attractiveness of the region for foreign and intra-regional business, and hence facilitate higher inflow of investments and generate higher entrepreneurial activity, trade, and ultimately jobs.
- Promote WB6 as an single investment destination

# Key challenge

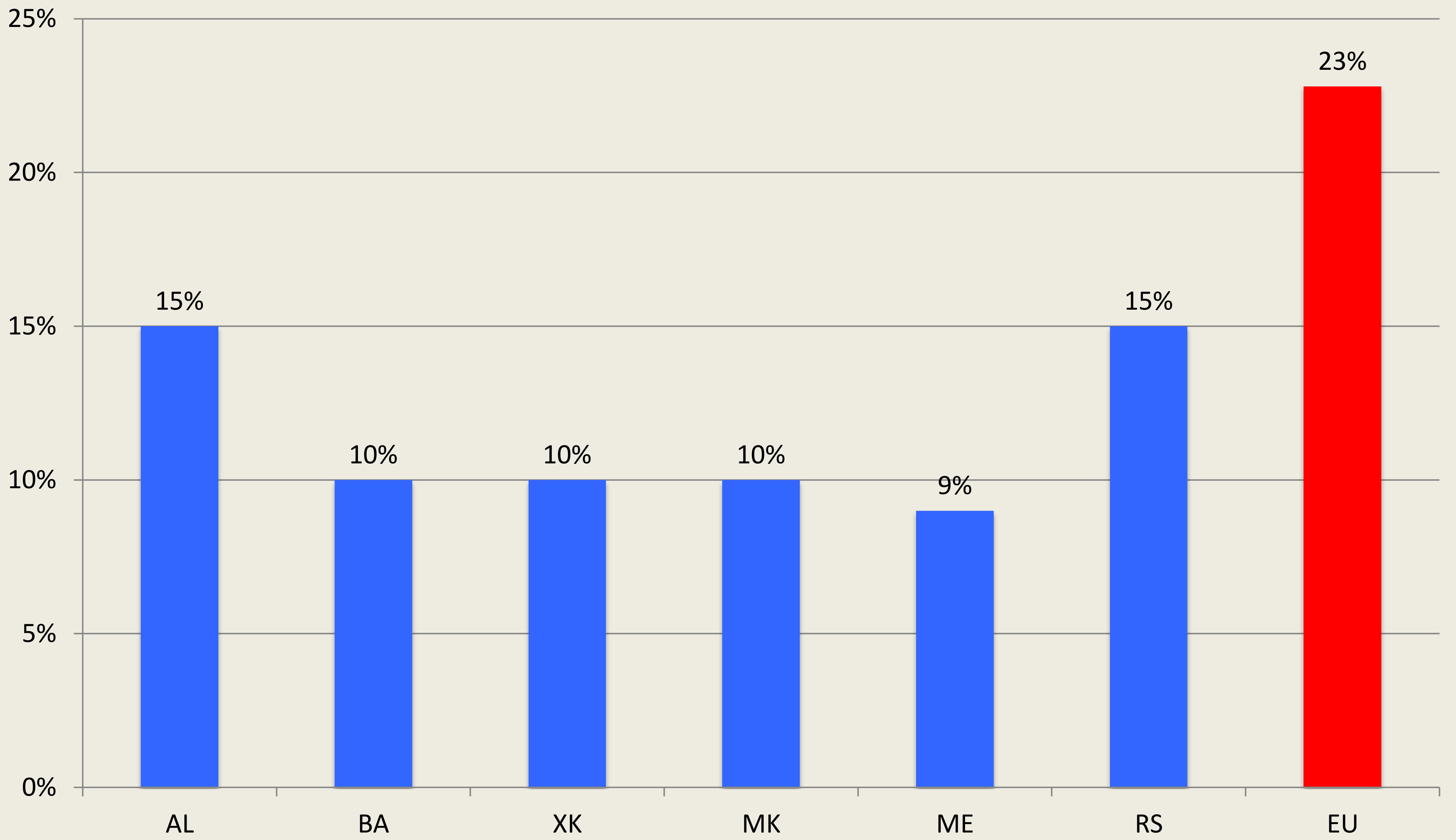
- Region has very poor record in attracting FDI
- WB6 compete with one another to attract foreign direct investment (FDI) through subsidies and tac breaks creating a “race to the bottom’
  - which makes it challenging for policymakers to reach agreements on harmonizing their investment promotion policies and cooperation.
- How to identify key areas of common interest in order to encourage cooperation among WB6 and recommend solutions with common interest
  - Move away from a “race to the bottom” to common platform for investment promotion and developing programs to support SMEs increase supply capacities to FDI
- The questions whether:
  - “the benefits to the host economy of the FDI do not exceed the cost of attracting it”?
  - The nvestment would have occurred regardless of the incentives – deadweight loss?
  - The Incentives effectively raise the bar so future investors will not now invest without similar or better subsidies

# Main gaps and needs for investment reform agenda

- Harmonized data collection for stronger evidence-based policy making
- WB6 economies should cooperate more to improve the business climate in order to attract increased inflows of FDI.
- Insufficient harmonization of investment policies with EU and international standards and best practices,
  - lack of coordination and transparency of the policies, the poor state of infrastructure,
- The inefficient implementation of national legislation, and the corruption proved to be considerable disadvantages in the attempts to attract FDI
- Improve the regional business climate by increasing cooperation on investment policy, including in the areas of: FDI-specific laws and international investment agreements, competition policy and business and trade facilitation, market access and infrastructure, skills regulatory weaknesses.
- Promote WB6 as single investment destination
- Increase the capacities of local supply base for FDI
  - Increase vertical and horizontal cooperation between companies

# Investment Incentives

# Corporate Income Tax Rates (%)



# Corporate profit tax exemptions

| | Standard rate | Within SEZ | Conditions |
|---|---|---|---|
| AL | 15% | 7.5% | Reduced tax rate for up to 5 years (200% deductions for R&D & training costs for first 10 years; 150% deductions for labour costs for one year) |
| BA | 10%<br>(FBiH 7%)<br>(FBiH 5%) | 10%<br>(FBiH 7%)<br>(FBiH 5%) | **FBiH**: Tax rate reduced to 7% if 50% of profit is reinvested in production equipment; to 5% if investing more than €10m (200% deductions of gross wages of new employees); **RS**: productive investment is tax deductible, as are income tax and social contributions when more than 30 workers are employed |
| XK | 10% | 10% | Not applicable |
| MK | 10% | 0% | Tax holiday within TIDZ is available for up to 10 years |
| ME | 9% (0%) | 9% (0%) | Tax holiday is available for €20,000 of profits for up to 3 years in an underdeveloped municipality except for agricultural products |
| RS | 15% (8%)<br>(0%) | 15% (8%)<br>(0%) | Tax holiday available within or outside SEZ for > €8m investment and > 100 workers; ten year duration 0% tax |

# VAT exemptions

| | Standard | SEZ |
|---|---|---|
| AL | 20% (Standard rate) | 0% for goods supplied to SEZs |
| BA | 17% | 0% (not implemented due to absence of by-laws) |
| XK | 18% (VAT Standard Rate 18 %; in essential goods 8%; in essential services and some other services including health services and education 0%) | not applicable |
| MK | 18% | 0% for goods supplied to TIDZs |
| ME | 19%; lower rate 7% on 16 items (Law on VAT, article 24a) | same |
| RS | 20%; lower rate 10% on 21 items (Law on VAT, article 23) | 0% for goods and equipment supplied to FZs |

# Serbian Investment subsidies

- Investment subsidies funded through the Serbian Development Agency (RAS) irrespective of SEZ location
  1. Subsidy is % of 24 months gross salaries, with % depending on level of municipal development
  2. Subsidy of % of investment cost depending on size of investment
  3. Additional subsidy depending on number of employees

# High cost of job subsidies

- Investors negotiate agreements with RAS
  - average subsidy of €9,000 per job created in 2014, and €5,000 in 2016.
  - 5,000 new jobs created under the programme in 2014, up to 17,000 in 2016.
- The cost of the programme was €45 million and increased to €85 million by 2016.
- The subsidies granted are almost equivalent to the investment per employee in FZs

# State aid

# Conditions for regional aid

- Aid should be granted only for the purpose of **initial investment**
  - Investment should be maintained for five years
  - Jobs should be maintained for 5 years
- Aid should be related to specific **regional development objectives**, not just to attract FDI
- State aid authority should be notified *ex ante* except under the General Block Exemption Regulation (GBER)
  - Aid for regional development with costs below €150m doesn't have to be notified *ex ante*
- State aid authorities should be **independent**
- State aid should be **transparent**

# State aid in the Western Balkans

| State aid % GDP | Bosnia | Montenegro | Serbia | EU-28 |
|---|---|---|---|---|
| 2013 | 1.52% | 2.88% | 2.25% | 0.44% |
| 2014 | 0.80% | 0.76% | 2.74% | 0.65% |
| 2015 | 0.55% | 0.53% | 2.62% | 0.62% |
| GDP per capita in PPS (%, EU-27=100) | 28 | 39 | 35 | 100 |

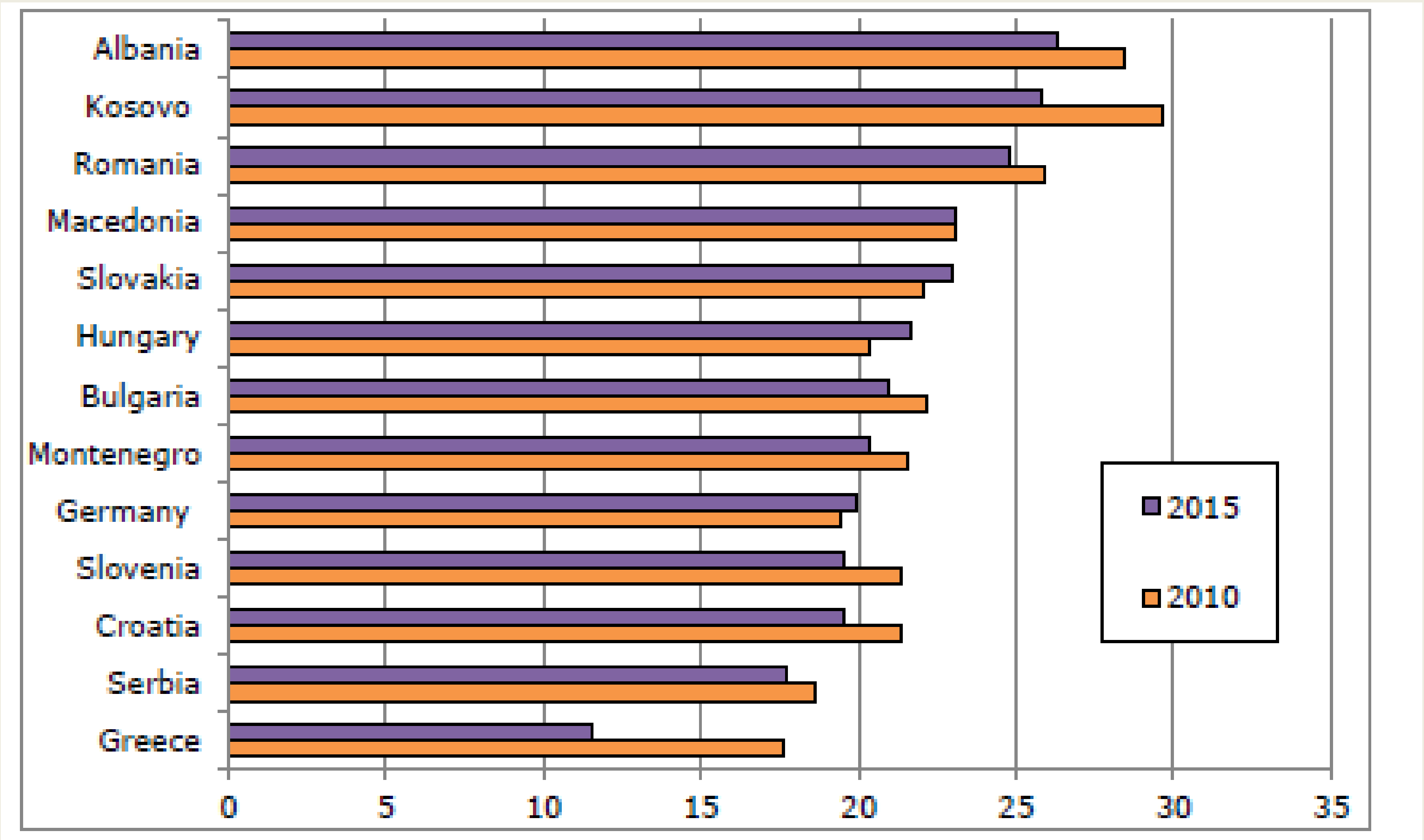
# Base Erosion & Profit Shifting (BEPS)

- Different tax rules in two countries opens opportunities for MNCs to avoid tax through profit shifting
  - EU companies can avoid tax by relocating parts of production process to Western Balkans (WB)
    - Whether within or without SEZ
- EU proposes to harmonise tax base, and later to harmonise tax rates
- **Main danger is to EU tax revenue, not WBs**
- Key problem is lack of transparency of WB tax regimes

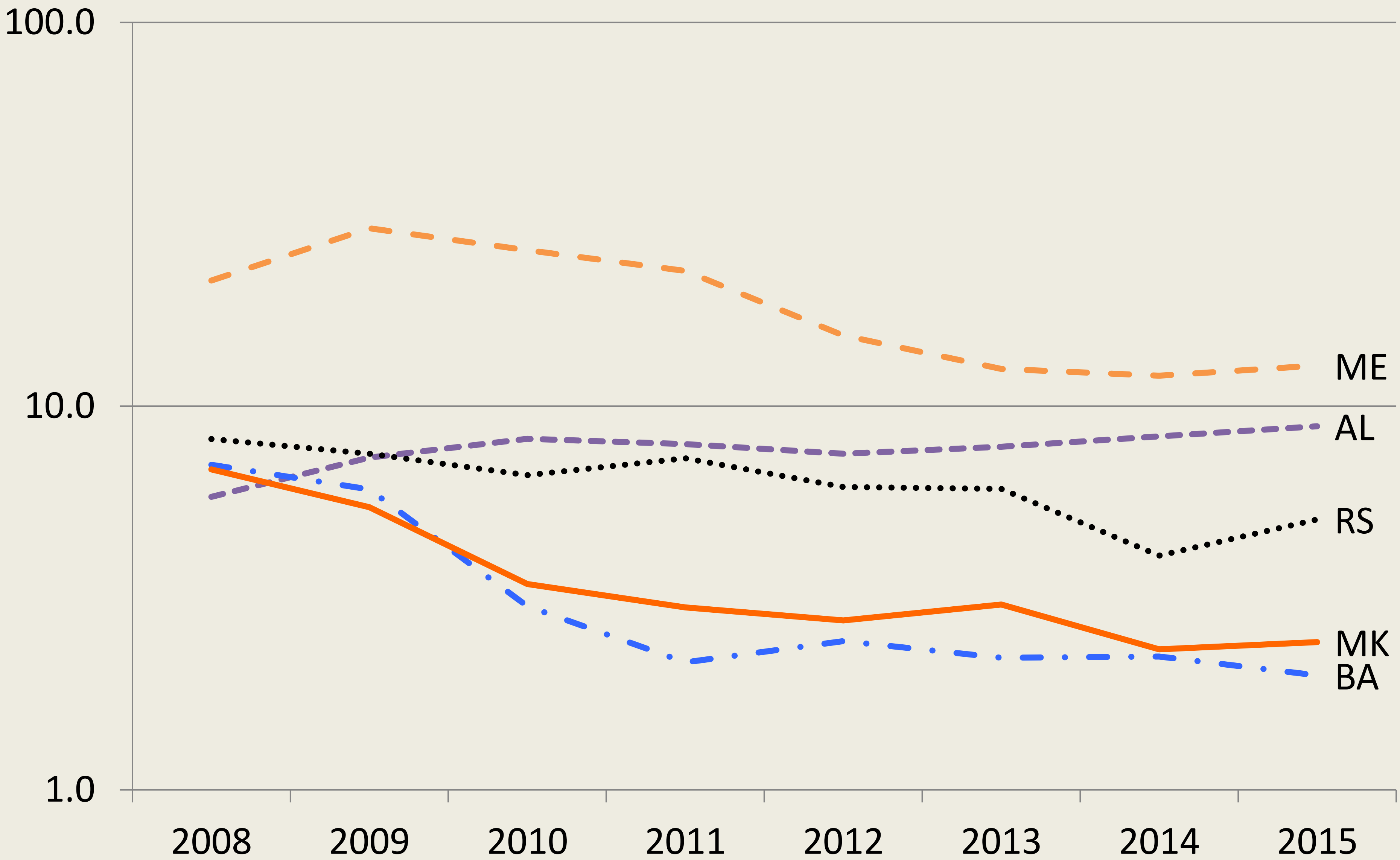
# Performance of SEZs

# INVESTMENT & PRODUCTIVITY

# Investment rates 2015 & 2010 (Gross fixed capital formation % GDP, Western Balkans and comparator countries )



# Flow of FDI to Western Balkans % GDP



# Investment in Serbian SEZs

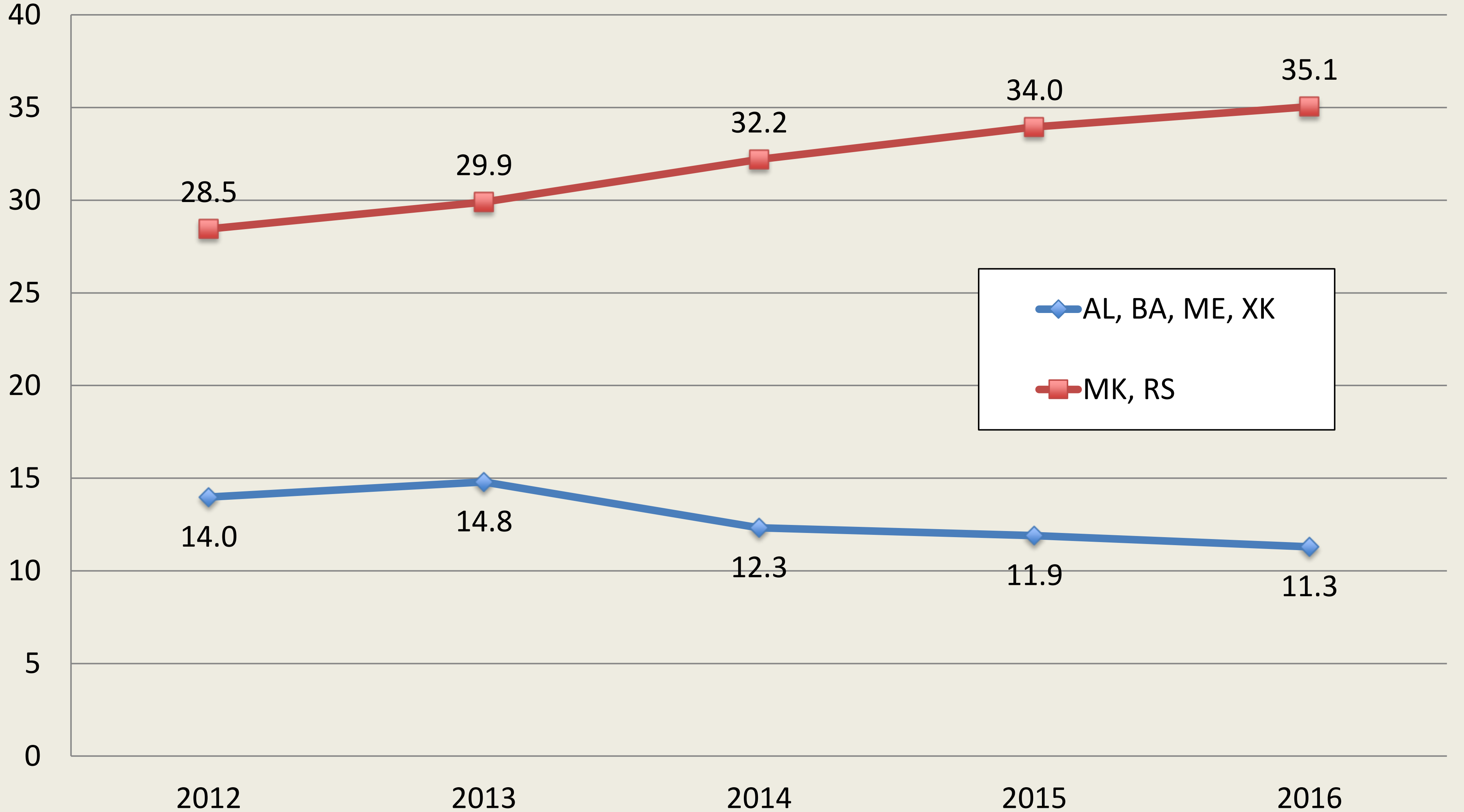
- Pre-crisis FDI was mainly directed to non-tradable sectors
  - Crisis reduced even this low inflow
  - New inflow of FDI has been into manufacturing
- In Serbia, biggest investment has been by FIAT in FZ Kragujevac (€1.3 billion in 2012)
  - Investment rate in FZs has been about 50%
    - (i.e. investment / gross value added)
  - By 2015, investment per employee in FZs was €7,000
    - Similar to per employee subsidies from RAS
  - A hidden industrial policy to boost productivity?

# Productivity by size group

- Value of output per employee in FZs is inversely related to the size of the companies they host
  - €199,000 in SEZs with small companies
  - €97,000 in SEZs with large companies
- Employment subsidies may have had a perverse effect of encouraging large companies to employ too many “surplus” workers, thus reducing productivity

# EXPORTS

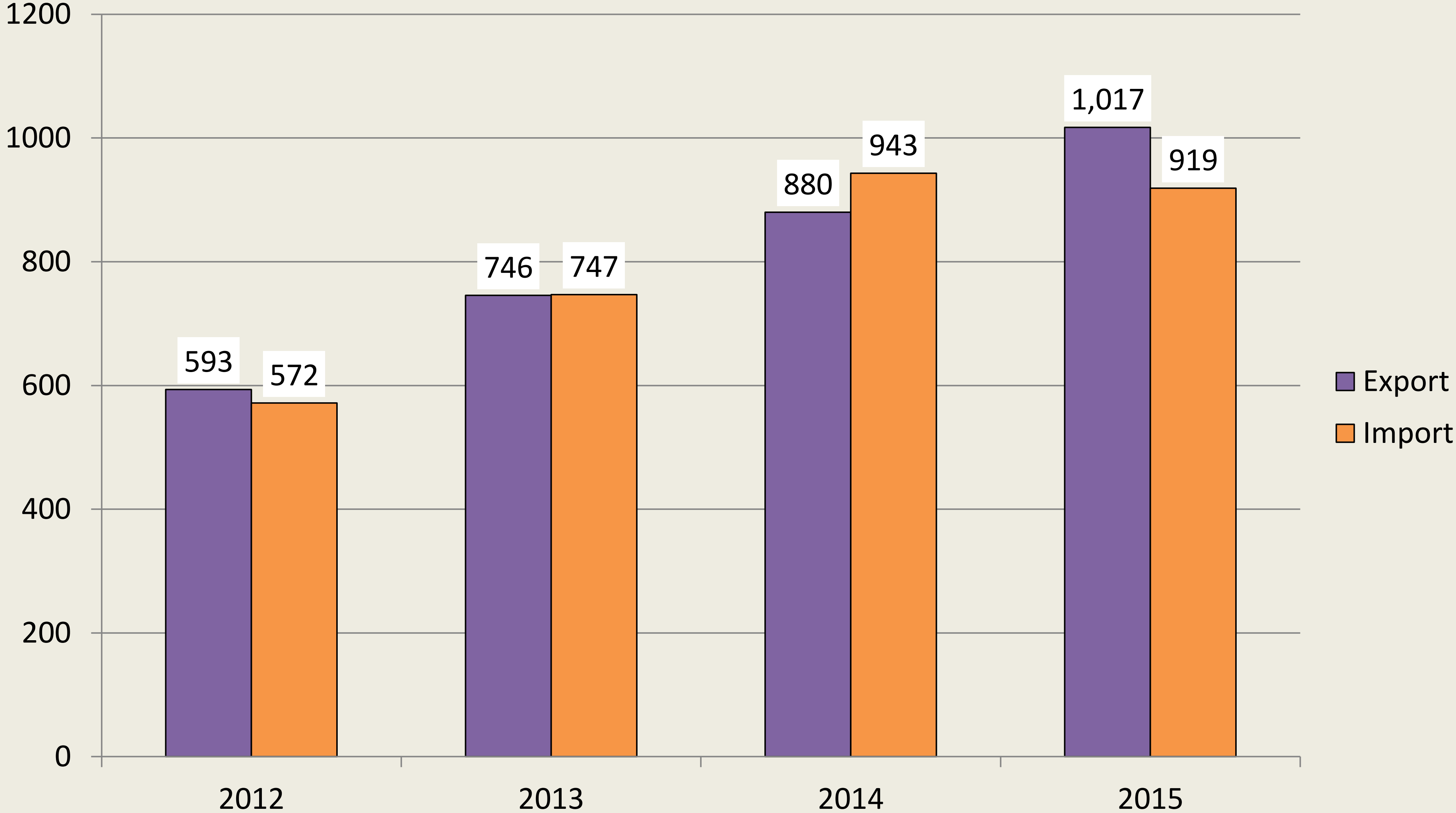
# Goods exports (% GDP)



# Improved trade performance

- In Macedonia, exports from TIDZ accounted for 35% of total exports by 2016
  - One company, Johnson Mathey, in "Skopje 1" TIDZ accounts for 16.4% of total exports
- Exports grew by 40% from 2013-2016.
  - Yet productivity failed to improve
- In both Macedonia and Serbia, the import content of exports from SEZ is extremely high
  - Around 80% - 100%
  - Indicates little impact on local economic development

# Exports and imports, "Group B" Serbian FZs (€m)

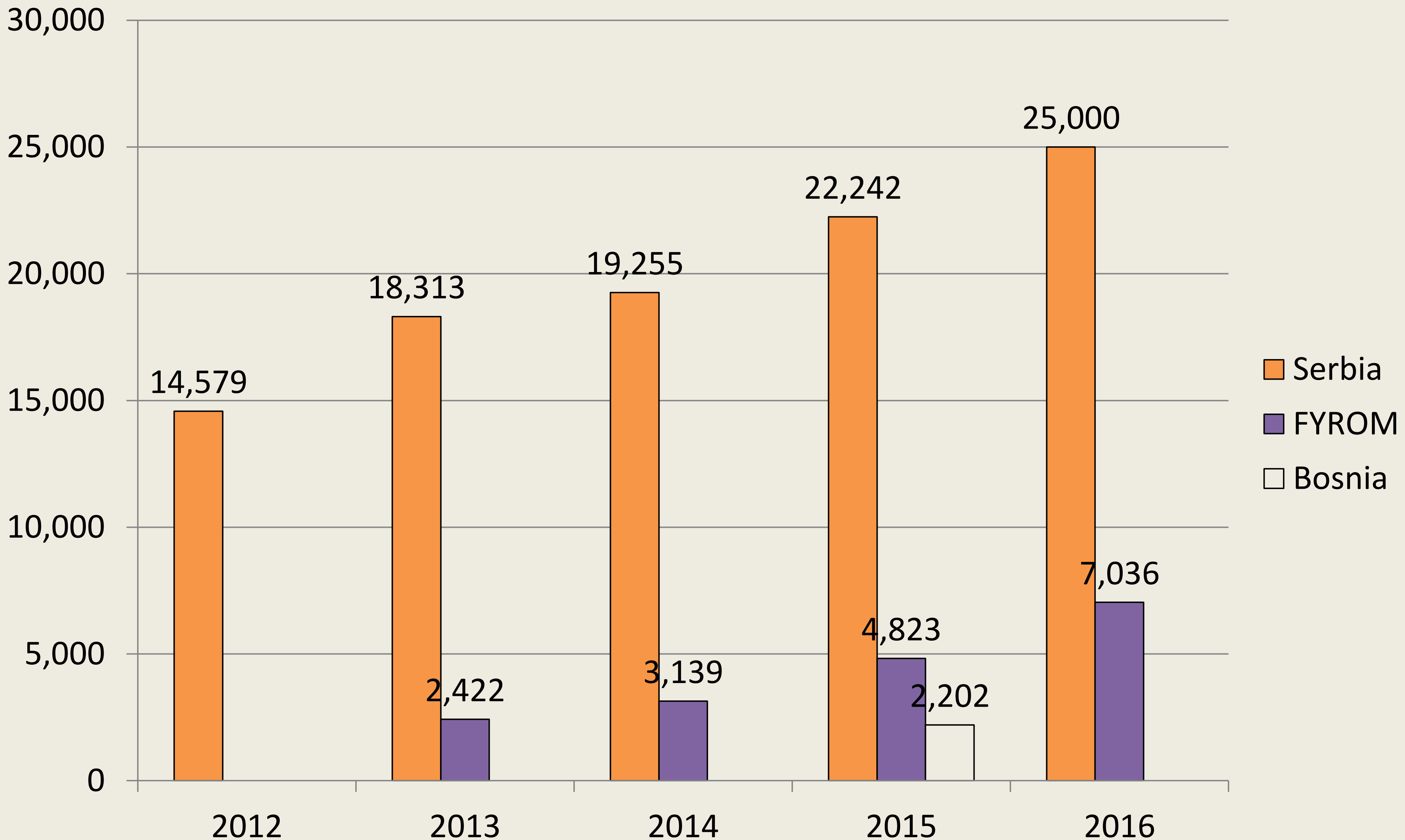


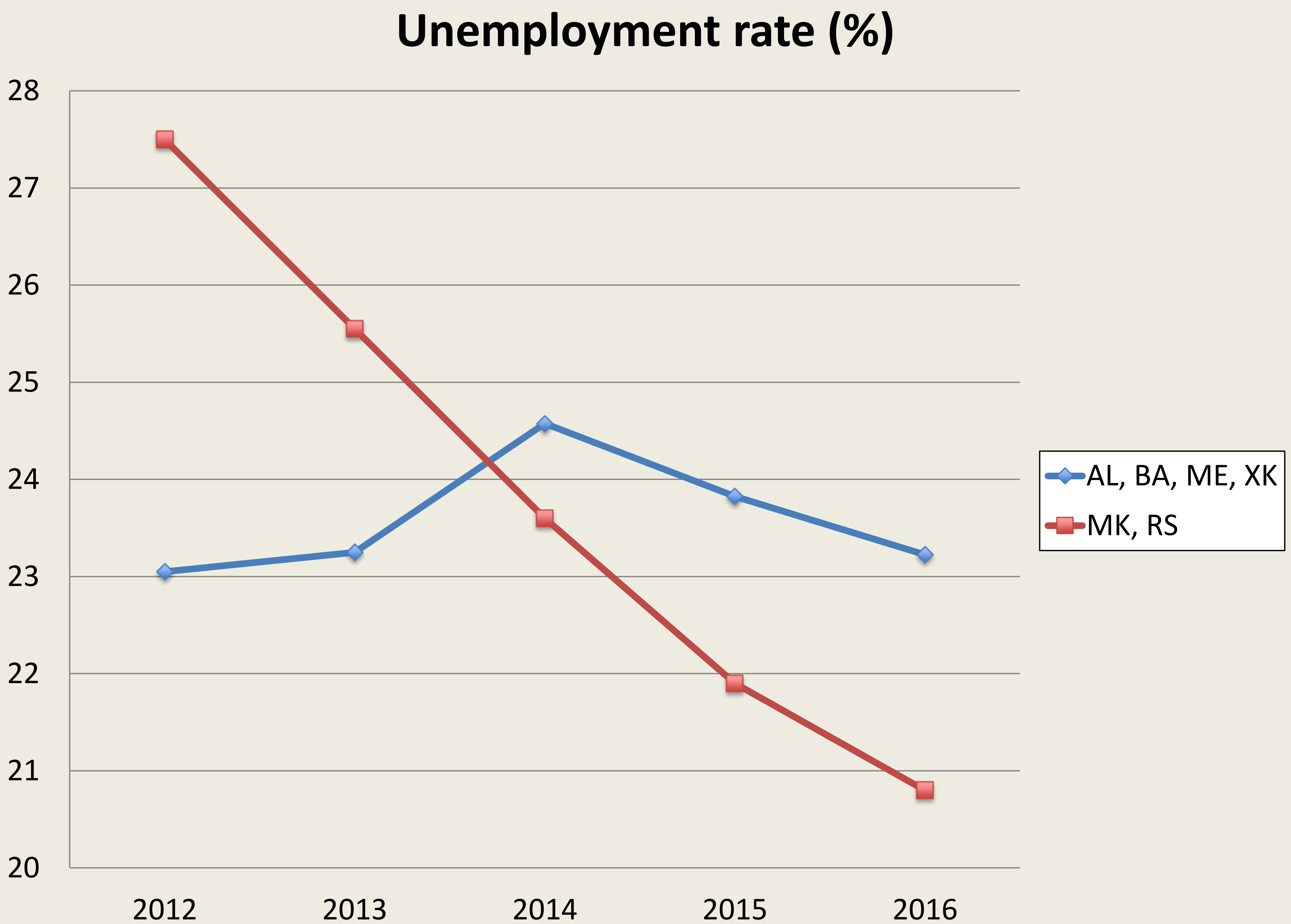
# EMPLOYMENT

# Direct and indirect employment effect of SEZs

- If SEZs attract FDI, they are likely to have strong direct and indirect employment effects
- **Direct effects** have been strong in Serbia
  - FZ jobs increased from 14,500 in 2012 to 25,000 in 2016
  - FZ jobs increased 5 times faster than in the whole economy
- In Serbia, for every job created by FDI, about 4 to 7 jobs are **indirectly created** in the local economy (RAS estimate)
  - Though this doesn't take into account displacement and deadweight effects, so is an upper estimate
- We estimate that between 25% and 50% of all jobs created in last few years have been due to direct and indirect effect of SEZs

# Employment in SEZs in 3 countries (2012-16)




Unemployment rate (%)
28
27
26
25
24
23
22
21
20
2012
2013
2014
2015
2016
AL, BA, ME, XK
MK, RS

# Serbian Development Agency (RAS) – job creation policy

- 19,550 jobs were created by FDI under RAS employment subsidy programme in 2016
  - With an average €5,000 subsidy per job, cost is €100 million
- Regional disparities in job creation persist
  - In Eastern/Southern Serbia, 3,686 jobs created mostly outside FZs
  - In Central/Western and Vojvodina, 14,914 jobs were created, mostly in FZs
- Most jobs created by German companies (5,274), followed by US (3,100)
- Most jobs in "New manufacturing parts for automotive industry" (5,760 outside FZs + 7,450 inside FZs = 13,210)

# SEZ and the local economy

# Use of local resources and suppliers

- Use of local suppliers varies between SEZs
  - In Macedonia – 500 local companies supply TIDZs
    - But,  only 5-10% of inputs are bought locally, usually limited to services, construction, transport, security services etc.
    - Very limited use local inputs for their core business operations
  - In Serbia – supply chain is virtually non-existent
  - In Bosnia – largest FZ Visoko, only 4% supplies sourced locally
- Large technology gaps often inhibit use of local suppliers

# Technology transfer

- In Macedonia there is some technology transfer is in evidence.
  - Example of Aktiva, which invested €7m to produce components for Van Hool and has bought a robotic welding machine ( the first one in Western Balkans)
- In Serbia there are few examples of technology transfer

# Workforce skills and local schools

- In Macedonia there is a shortage of skilled workers in localities around larger TIDZs
  - Risk that pool of skilled labour will quickly become exhausted
  - Upward pressure of wages for skilled workers
  - TIDZ companies sending employees abroad for training
- In Serbia there is a similar picture of emerging skill gaps
  - Some companies cooperate with local vocational schools to modernise curricula
  - GIZ project on dual education: first batch of graduates all found jobs with Bosch

# Field interviews with SEZs’ company managers

| The most effective investment incentives in attracting FDI | Use local materials and labour | To what extent and in what ways do SEZs contribute to technology transfer to local companies? |
|---|---|---|
| • Tax incentives<br>• Incentives for employment<br>• Land ready for investment<br>• There was no autocracy, we did not wait at all<br>• The availability of labour, especially near main cities,<br>• The low labour cost | • Use almost entire workforce locally, with very few exceptions for higher managerial positions<br>• SEZs companies use outside purchasing outside WB because is difficult to find adequate inputs,<br>• Reliability, price stability and quality standards remains the biggest concern for increasing use of local supply base<br>• Cooperation initiatives between SEZs companies and local suppliers  usually starting with small projects and gradually increasing progressively<br>• In one case (in FYROM) the company has been able to become part of the global value chain of the FDI company in SEZs<br>• Limited supply – there is a need for cooperation between WB6 companies in certain sector | • The singed contracts for sales has enabled local companies to have more risk-free expansion plans to buy new equipment<br>• We have provided know-how for local companies, organised visits in our mother companies to have direct experience how we work and what is required<br>• Provided training for local staff especially in engineering  work |

# Conclusions & recommendations

# Policy and institutional framework

- WB6 should compete on the basis of quality and efficiency of services offered rather than subsidies
  - and avoid a "race to the bottom"
- Governments should adopt a regional approach to attracting investment,
  - not compete against each other through tax incentives
  - Leverage cooperation between WB6 companies to increase the supply base
    - **Good example Purchasing Initiative Western Balkan – Einkaufsinitiative Westbalkan (next slide)**
- Governments should regulate but not develop SEZs,
  - SEZs should be based on local initiatives that are more responsive to business needs

# Purchasing Initiative Western Balkan – Einkaufsinitiative Westbalkan.

- After the positive result with more than 400 participants in the last Purchasing Initiative Western Balkans,
- the BME and its partners are now organizing a new edition of the **Purchasing Initiative Western Balkan – Einkaufsinitiative Westbalkan.**
  - **The fourth edition takes place on the 19th of June at the IHK Frankfurt in Germany.** Interested German Buyers will meet around 100 preselected Supplier from Serbia, Croatia, Bosnia and Herzegovina, Macedonia, Montenegro, Albania and the Kosovo.

# Incentive structures

- Corporate income tax holidays should be avoided
  - where they are linked to export performance they may infringe WTO rules (for members)
  - they may also encourage foreign investors to engage in profit shifting and tax avoidance (more implications for EU rather than for WB6)
- Home countries should assist WB6 to develop local supply chains in exchange for abandoning tax holidays for foreign investors
- Governments should avoid non-transparent and secret negotiations over subsidy packages for FDI

# Developing the local economy

- Governments in the Western Balkans should put more effort into developing local supply chains for SEZs and FDI in general
  - This should be based around greater support for local SME ecosystem
  - EU can support this through EDIF and EBRD investment
- Governments should encourage cooperation between SEZ companies and local educational institutions to boost supply of skilled labour

# Implement BEPS framework

- Governments should ensure greater transparency of tax systems
  - especially in relation to tax exemptions for foreign investors in SEZ and more generally
- Greater coordination of tax regimes should be envisaged, including harmonisation of the tax base
- Tax holidays should be avoided and replaced by
  - greater efficiency of SEZ management
  - upgrading the local SME supply chain
  - increasing skill level of local labour force by investing in education and life long learning

# Recommendation 3

- The need for restriction of strong national policies to attract FDI which are against the state aid regulation would be a first step towards joint investment agenda.
- WB6 authorities to agree on potential areas of cooperation including which sectors should be prioritised.
  - such as tourism, and local suppliers in certain industries ICT, Textile, automotive industry
- The formation of a formal structure of investment promotion agencies for the WB6
- Some activities may include:
  - investment promotion portals,
  - organise international investment conferences,
  - promote the use of technology-based solutions,
  - Sector briefings and participate jointly at international and regional trade industry shows, especially within the target sectors.
  - Advocate the regional investment reform agenda, appointing specialised staff for regional promotion within investment promotion agencies,
  - Creating a database of suppliers’ in the WB6 region,
  - Regional B2B meetings with local suppliers from the WB6 economies and FDI

# Recommendation 4

- Harmonization of data on investment and intra-regional investment by sectors
  - Capacity building for staff
- Review domestic laws and regulations in the WB6 for inconsistencies with entry and establishment non-discrimination principles and publish a consolidated list of legal entry barriers to increase transparency for investors.
- Upgrade domestic legislations in line with standards provided in new generation IIAs
- Support the development of a business portal to catalogue, provide and compare information on procedures to establish and operate a business in the region
- Compare, review and align where possible business registration requirements on regional level.
- Facilitate and expedite work permit and affiliated procedures on economy level

**Thank you for your attention !!!**