

eme

**A report for the Organisation for Economic
Co-operation and Development on the Role
of Taxation in Foreign Investment in South
East Europe**

EMERGING MARKET ECONOMICS (eme)

JULY 2002

Emerging Market Economics

3 Millharbour

London E14 9XP

Tel: +44 (0) 20 7538 3111

Fax: +44 (0) 20 7538 3130

www.emergingmarkets.co.uk

TABLE OF CONTENTS

Introduction	2
Foreign Investment Trends in Central and South East Europe	16
Survey Results	27
Case Studies from Investor Survey	38
Investment Decision Process and Key Determinants	49
Conclusions	54
Appendix I: Investor Survey	57

I. INTRODUCTION

1.1. Objectives, process and Report Content

In September 2001, the OECD commissioned Emerging Market Economics Limited (**eme**) to design and conduct an investor survey that would provide insights into how tax incentives, tax policy and the administrative burden of taxation affect corporate investment decisions in South East Europe. The interpretation of the results would draw on **eme**'s experience and expertise in helping corporate clients screen countries for investment and manage emerging market risks. The report is intended to help the OECD achieve the following objectives:

- Establish the process by which corporates identify countries for investment
- Increase understanding of how taxation factors, including taxation incentives, influence investment decisions
- Identify which forms of taxation are considered important to the investment decision.

The following countries were considered to be part of South East Europe for the purposes of our report: Albania, Bulgaria, Federation of Bosnia-Herzegovina, Republika Srpska, Croatia, Macedonia, Moldova, Romania, Serbia and Montenegro.

This report sets out **eme**'s survey methodology, documents the overall survey results, details a small number of case studies and sets out the process through which investors make their decisions. The report is organised as follows:

1. **Introduction** – the remainder of this section comprises a literature review, supplemented with insights gained by **eme** in its work with corporate clients, to develop a conceptual framework for the factors that affect foreign direct investment (FDI) and discusses the role of taxation. It serves to explain the content of the investor survey.
2. **Foreign Investment Trends in Central & South East Europe** – this chapter provides the empirical background to the survey, helping to test the influence that

changes in the investment climate, especially taxation, have had on investment flows.

3. **Survey Results** – provides a general overview of the survey results in quantitative terms, including findings on key issues such as the role of taxation and the types of taxation that matter to investors.
4. **Case Studies from Investor Survey** – we take a number of responses that provided the most comprehensive feedback on taxation issues and set out and interpret their responses.
5. **The Investment Decision Process and Key Determinants** – A review of how a number of **eme**'s corporate clients approach foreign investment. This identifies the key indicators used to evaluate country attractiveness and assesses the importance of each factor to the final investment decision.
6. **Conclusions** – an overview of what the survey results imply, what the OECD can conclude about the role of taxation and types of taxation in the investment decision making processes.

1.2. Foreign Investment and Emerging Markets

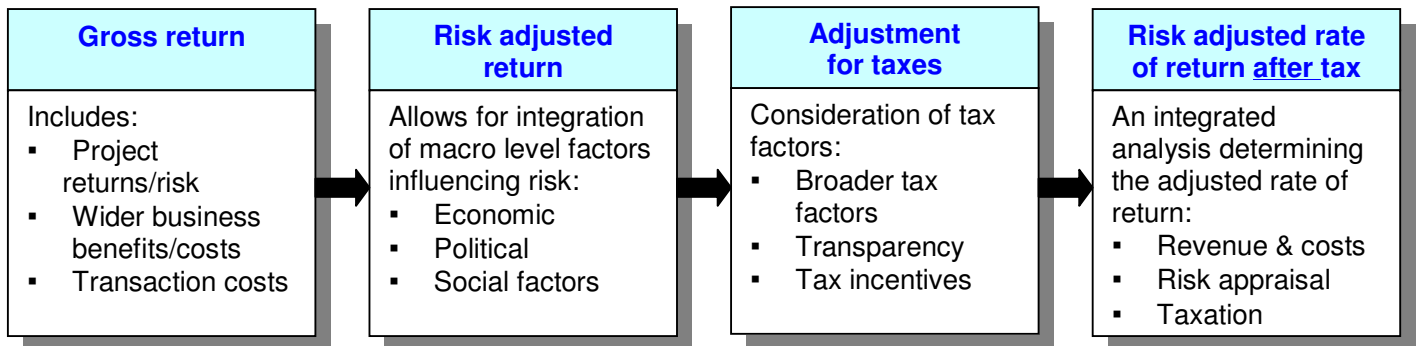
Investment decisions by corporates are essentially based on the net profitability of a venture and the level of risk. Higher levels of risk increase the uncertainty and downside volatility of any estimated return from the investment, and thus decrease the attractiveness of the investment. Investors are willing to expect lower returns for lower levels of risk and vice versa. Investments in emerging markets are often made on the presumption of an attractive business proposition, but accompanied by a higher perceived level of risk.

Companies incorporate these real and perceived risk factors into their discount rate, increasing the minimum expected returns from the investment before any investment is undertaken. Typically, companies look at the premium charged (over LIBOR or other international benchmarks) for the target country's sovereign debt to determine

the extent to which the discount rate used in their home country (reflecting their cost of capital) must be increased to reflect higher sovereign risk in an emerging market. In essence, the increased discount rate is expected to cover the risk of the country defaulting on its foreign debt, an event that would make it very difficult for the investor to repatriate dividends and/or capital.

There are also a very large number of other forms of risk that the investor needs to take account such as cyclical, political, governance and, increasingly, reputation risk¹ that may be higher in an emerging market than in its home base. In the past, many corporates used to allow for such risks through the discount rate but the current practice is to treat such factors as project risk. Cash flows are adjusted for the probability and likely impact of such risks, rather than increasing the hurdle rate of the discount factor.

The basic process of arriving at cash flow projections, and the role of taxation within that calculation, is illustrated below. It is the risk adjusted cash flow after tax that is then subjected to discounting by the cost of capital adjusted for sovereign risk²:



As one would expect, there is in practice a wide range of techniques and modelling tools used to estimate the profitability of projects. More sophisticated companies use detailed scenario planning to model the probability and impact of risks and discount the resulting cash flow using scenario weighted projections of revenues and costs and using a discount rate that takes account of undiversifiable sovereign risk. Less

¹ Political risk covers instability of governments with consequent changes of policy. Governance risk covers all the risk resulting from lack of transparency in the application of legislation and regulation as well as access to the rule of law. Reputation risk covers risk arising from a companies social and environmental impact that may be damaging to society and in turn damage its corporate reputation.

sophisticated corporates use simpler techniques such as payback periods, accounting for risk by setting shorter periods the greater the risk.

The treatment of risk and how it affects the investment decision is of vital importance to understanding investor behaviour in the emerging market context. Based on it, it becomes clear that governments able to provide investment conditions that reduce sovereign and project risk would, other things being equal, help to increase the attractiveness of opportunities to investors. Such conditions are often referred to as *enabling environment*. There is a considerable body of literature on what may constitute an enabling environment, as discussed below.

Previous Studies on the Determinants of FDI

Studies have attempted to explain the relationship between increased FDI flows and a number of explanatory variables. The results of the research undertaken have succeeded in identifying a number of general factors that influence a country's ability to attract, absorb and retain foreign direct investment. This goes some way to helping us identify the factors that make for an enabling environment for foreign investment and the role of taxation within that environment.

Paul Estrin in an analysis of FDI flows into Central and South East Europe articulated and empirically verified a number of key location factors in determining FDI. These included: host country market size, input costs, natural resources and labour, and the risk inherent in the investment – both in terms of the economic and political environment³.

Guy Pfefferman differentiated between those countries that had inherent attractions such as a large expanding market, and those countries that had to make themselves attractive to foreign capital because they lacked such natural attributes. Those countries that lacked an 'inherent attraction' but nevertheless were successful in attracting FDI met five fundamental development conditions:

² Risk within the Gross return is internal project risk that is intrinsic to all individual investments.

³ Bevan Alan S, and Saul Estrin. "The Determinants of FDI in Transition Economies" *London Business School, Centre for New and Emerging Markets*, October 2000. Page 7.

- Law and Order
- Secure property rights
- Enforceable contracts
- Functioning financial systems
- Market determined prices – including exchange and interest rates⁴.

All the above factors address forms of risk.

Many studies refer to Dunning's work that established three sets of influences on FDI. These include:

- Market factors, such as size and growth of the economy and specific product market;
- Cost Factors, such as the availability of labour, labour costs and inflation;
- The investment climate, including sovereign risk, as measured by the degree of foreign indebtedness and state of the balance of payments⁵.

Using a different model, a paper by Saskia K. S. Wilhelms for the United States Agency for International Development used the concept of Institutional Fitness to articulate variables upon which FDI is dependent. The paper identified four key aspects of Institutional Fitness as being:

1. Government Fitness
2. Market Fitness – Including Overall Market Fitness, Goods and Services Fitness, Capital Market Fitness and Market Linkage Fitness
3. Educational Fitness
4. Sociocultural Fitness⁶.

By using the concept of Institutional Fitness, the paper sought to test the hypothesis that there was a strong correlation between these factors and increased FDI flows.

⁴ Guy Pfeffermann "Low Income Countries: Prospects for Increasing Capital Inflows – Focus on FDI". *Chief Economist. IFC*. December 1996. Page 5.

⁵ Nina Bandelj. "Embedded Economies: Determinants of Foreign Direct Investment in Central and Eastern Europe", *Department of Sociology, Princeton University*. 1999. Page 12.

⁶ Saskia K. S. Wilhelms. "Foreign Direct Investment and its Determinants in Emerging Economies", *African Economic Policy Paper funded by United States Agency for International Development*, July 1998. Page 7.

The paper measured the relationship between Institutional Fitness and FDI inflows in 67 emerging economies between 1978 and 1995. The model found that governmental and market fitness play a central role in attracting FDI. Government fitness consisted of economic openness to investment and trade, law and order and a corruption free environment. Market fitness was reflected in an appropriate taxation system (provided by a reasonable level of incentive for business to retain and increase profits), high trade volume, strong financial intermediation and sound urban and rural infrastructure. Urbanisation was positively correlated with FDI flows through institutional concentration and residential sophistication. Other variables such as location, socio-cultural fitness and total population were not found to have significant correlation with FDI inflows⁷.

In their econometric analysis of transition economies in Central and Eastern Europe Bevan and Estrin established that FDI flows are determined by sovereign risk, unit labour costs, host market size and gravity factors. The level of sovereign risk, as reflected in credit ratings, was found to be strongly influenced by private sector development, industrial development, the government's budgetary balance and reserves, and corruption⁸.

An approach by Harinder Singh and Kwang W. Jun separated developing countries into those with comparatively high FDI flows and those with lower FDI flows. They found that a qualitative index of political risk is a significant determinant of FDI flows in countries that have historically attracted high FDI flows. For countries with low FDI flows, socio-political stability, measured through work hours lost in industrial disputes, has a negative impact on FDI flows.

Thus there seems to be considerable consensus in the literature that a combination of market attractiveness, measured by size and growth of the market, cost factors and conditions that make for the stability and predictability of the operating environment make a country attractive for FDI. The former affects the projected

⁷ Saskia K. S. Wilhelms. "Foreign Direct Investment and its Determinants in Emerging Economies", *African Economic Policy Paper funded by United States Agency for International Development*, July 1998. Page 32.

⁸ Bevan Alan S, and Saul Estrin. "The Determinants of FDI in Transition Economies" *London Business School, Centre for New and Emerging Markets*, October 2000. Page 3.

profitability of the venture and the latter the risk. From the literature, the development of enabling conditions for attracting foreign investment and so the foundation for the development of policy appears to include the mitigation of risk.

However, the above studies also serve to illustrate that no agreed definition of what constitutes an enabling environment for foreign investment has emerged. This serves to illustrate Singh and Jun's assertion that a broad consensus on the determinants of FDI have proved elusive⁹. Nor is there an agreed model to provide the basis of empirical work¹⁰.

Attempts to define the determinants of FDI have suffered, both through the breadth of modern capital flows, and often, the subjective nature of the investment opportunity itself. Motivations for investment are often as varied as the subject of the investment itself, undermining attempts to develop a comprehensive list of factors that influence the flows of inward foreign direct investment. Additionally, general statements such as the necessity of political stability are often not demonstrated empirically.

What the literature research undertaken above does do is to help identify a range of factors that might have been considered in or influenced the final investment decision. It does not help to address the problem of how investors view such issues within an individual risk-reward structure nor explains why, in some circumstances, investors continue to invest in countries that do not meet certain fundamental criteria identified in the literature.

1.3. Establishing the Role of Taxation Factors in Foreign Investment Decisions

What role does taxation have in the investment decision? Companies seek to maximise their profits after tax, so a decrease in the taxation exposure of the company should serve to increase the return to shareholders. Taxation factors such as corporate tax rates and base, indirect tax rates and base and tax incentives are

⁹ Hardiner Singh and Kwang W Jun, *Some New Evidence on Determinants of FDI in Developing Countries*. Page 4.

¹⁰ Bevan Alan S, and Saul Estrin. "The Determinants of FDI in Transition Economies" *London Business School, Centre for New and Emerging Markets*, October 2000. Page 7.

usually built into cash flow models, either explicitly as model variables or dealt with separately in a tax planning exercise. Companies that manage to achieve reduced tax exposure in one project would choose it over an identical project that has the same level of risk and return with a higher taxation burden. This much appears self-evident.

However, while taxation may be an important determinant of after-tax profitability, and therefore be seen a priori as an important investment determinant, the overall role of taxation and specific taxation factors within the investment process is often not defined. The range and complexity of tax regimes and the fact that their incidence and importance varies with the nature of the investment opportunity, makes the exercise difficult.

The investor may view taxation from a number of different standpoints:

- Corporate tax may affect the net return to the investment;
- Indirect tax affects the final price paid by the consumer and hence the level of demand. In turn, the level of demand may affect the level of profitability of the venture;
- Taxation can be viewed as a risk factor (e.g. the predictability of tax policies and administration);
- It may be regarded as a transaction cost because of the administrative burden it places on companies.¹¹

From whichever stand point investors view tax, the importance they place on it depends also upon their level of confidence in predicting other factors likely to affect project outcomes. For investors confident of the level of returns that their venture will generate, taxation could be the most important factor. An example of this is highly mobile financial services such as off-shore fund management that are not dependent upon the local operational environment. Increasingly, such funds are choosing tax free locations. On the other hand, for investors that are affected by factors such as market size or cost of inputs and are subject to risk factors such as sovereign or political risk, levels of taxation may play a very small role in determining investment location.

In general, it appears that studies show that taxation or tax based incentives play a relatively minor role in the choice of location for investment. In his study into the flows of foreign investment, based on survey data, Robinson found that government officials held tax concessions in a much higher regard than investors. Investors articulated such factors as liberalised capital and profit repatriation rules as more influential on the location decision than taxation.¹²

Further, many studies suggest that taxation's influence on the investment decision becomes significant once a shortlist of locations has been arrived at. Evidence suggests that incentives are rarely the main location criteria, but influence the decision during the latter stages of the investment decision process¹³ after other factors have been used to determine locations that will offer attractive pre-tax returns to the venture.

Further evidence of the rather weak effect that tax levels have on the choice of location comes from examining the effect of tax incentives on choice of location. The view of many studies is that incentives serve to divert investment to particular industries but have little effect on the overall level of investment in the country. In a 1985 study, Guisinger and Associates confirmed the importance of incentives at a later stage of the decision process. They concluded investors did not consider incentives as a determining factor in their investment if they were more or less matched by competitor countries¹⁴.

The importance of the various types of tax (and hence tax incentive) varies with the nature of the investment –scale and gestation period of the investment, type of industry (consumer or capital good) etc. Different types of investments are impacted more or less by specific forms of taxation/incentives than others. For long gestation, capital intensive projects, what matters is capital allowances/tax free periods and the number of years they can be carried forward. For financial services, the level of

¹¹ In countries such as Egypt the system of taxation can represent a huge burden on companies.

¹² Bergsman, Joel and Neda Pirina. "Do Incentives Work?" *FIAS Publications*, March 1996. Page 2.

¹³ PricewaterhouseCoopers. *Industry Victoria: The Role of Incentives in Attracting Investment*. Page 8.

¹⁴ Bergsman, Joel and Neda Pirina. "Do Incentives Work?" *FIAS Publications*, March 1996. Page 3.

withholding and capital gains taxes may hold equal importance to corporate tax. In general, incentives available at an early stage of the investment and those which are immediately and precisely quantifiable are cited as having greater decision making influence¹⁵.

Thus, to understand the relevance and importance of taxation issues within the investment decision, it is necessary to establish the nature of the foreign investment. In general, taxation will exert the greatest influence over investments where returns are largely independent of country specific factors of the operating environment. Investors in highly mobile industries are likely also to take account of taxation early on in the decision making process. For investments dependent on country specific factors such as the attractiveness of the market, cost of inputs and subject to sovereign and other forms of risk, taxation is likely to have much less influence on the location of investment decision. For such investors, taxation issues would be considered only after other factors that make up the operating environment have been found satisfactory. Typically, taxation would be important to the location of investment only if other investments are found to offer roughly similar risk/return ratios.

1.4. Developing a Conceptual Framework

Whilst studies are useful in providing insights as to the factors that influence choice of location and the role taxation plays in the decision making process, they do not provide a 'map' of how the various factors come together to form the operating environment and make it more or less enabling. Further, they do not point to the need to fully understand the nature of the investment before attempting to model the behaviour of investors.

We believe that it is important to take account not only the nature of the investment but also the basic *motivation* of the investor in order to better understand investor behaviour. A useful tool is to distinguish investors by their motivation with regard to investment, either opportunistic or strategic. For *strategic* investors, investment

¹⁵ Bergsman, Joel and Neda Pirina. "Do Incentives Work?" *FIAS Publications*, March 1996. Page 3.

decisions are usually made on the basis of wider investment considerations, such as securing presence in markets with the potential over time to become sizeable by international standards, maximising competitive advantages of scale or cost of production, or how the country fits with the wider global business strategy in terms supplying goods and services to a particular region.

Opportunistic investors, alternatively, focus on assessing a target investment on the basis of its profitability and do not perform comparative assessments of countries as the opportunity is usually specific to a time and place. What they hope to identify is unique projects that provide high levels of risk adjusted returns over a short period of time.

This distinction has an important implication that relates to the fundamental framework of foreign investment as detailed in Part I of this section, and the role of taxation within that framework. For the strategic investor, the decision to invest is often driven by considerations that may not be captured by the returns to that investment (e.g. economies of scale). The critical decision is *where* to invest. For the opportunistic investor, the critical decision is the level of returns to the investment and the timeframe of that return.

We expect that for the majority of strategic investors, taxation issues are considered alongside other factors that influence the risk/return ratio and are considered both at the initial screening stage of the investment process and afterwards when appraising the returns in the project. For the opportunistic investor, tax regimes are part of the estimation of the returns to the investment and so are considered earlier in the investment process. But tax factors may be less important. The key decision is the profitability of the specific opportunity. Provided that this is high, tax may not be critical to the investment decision. An effective segmentation of different investor types is therefore the first step in understanding the relative importance of taxation issues for the simple reason that taxation influences investors in different ways.

For the strategic investor, for tax policy to be attractive, what matters is a stable, predictable and low burden of taxation over the long run. Their profits are likely to

grow because of the development of markets and/or economies of scale, and therefore need to be assured that tax burdens will not increase in the future. For the opportunistic investor, what matters is the ability to maximise profits in the short run, therefore short-term tax incentives such as tax free holidays and accelerated tax benefits are more important.

Based on this approach it is critical to have regard not only to other factors that were considered in the investment process, but the primary motivation of the investment in question. This approach provides the foundations of a broad investigation of taxation issues relating to foreign investment that we believe offers better insights than the studies above. In particular, it helps to explain why the empirical evidence does not often support the hypotheses put forward by various academics.

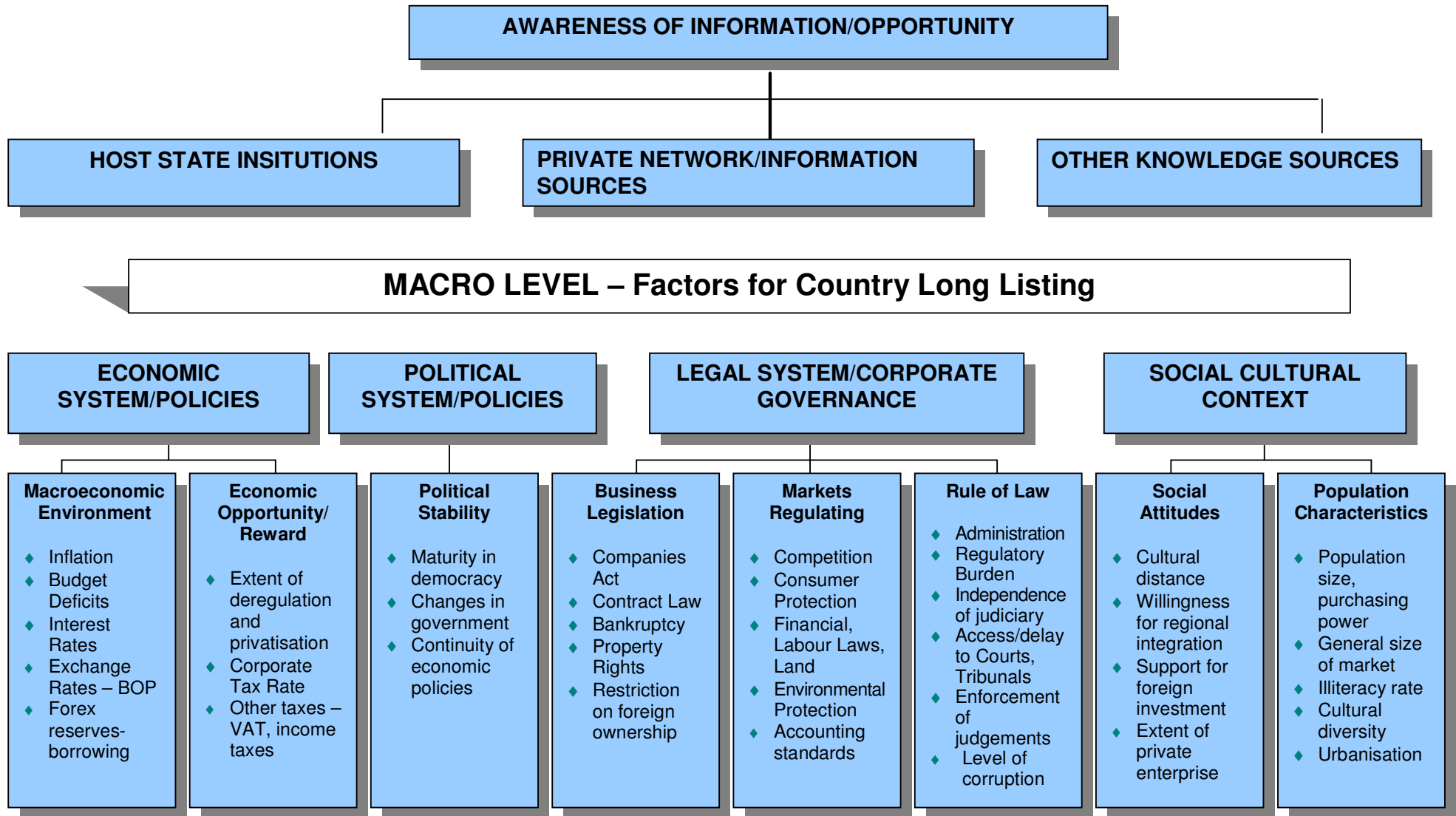
Based on discussions with investors and drawing from the literature, it is possible to draw a map of the factors that affect the choice of investment location, as shown in figure 1 below. The first factor is, of course, the availability of information on the alternatives available. For a comparatively under developed destination, the first objective must be to make itself and/or specific opportunities known to potential investors. As countries start to attract investment, there is a tendency for a 'band wagon' effect to take place with the competitors of companies that have already located and new industries following the first movers to the destination.

For strategic investors in relatively mobile industries, the process of selection often starts with long listing a set of countries based on macro level criteria. The economic system, level of opportunity and reward (including overall levels of tax), political and governance risk and the social/cultural context help determine the extent to which an enabling environment exists for foreign investment. Having developed a long list, short listing is likely to take account of transaction costs that are determined largely by the state of development of the various forms of infrastructure –physical, social, business - and business networks. The final set of factors to be considered would be micro level and/or project specific. The focus at this point would be the profitability of the venture and the actual level of tax payable.

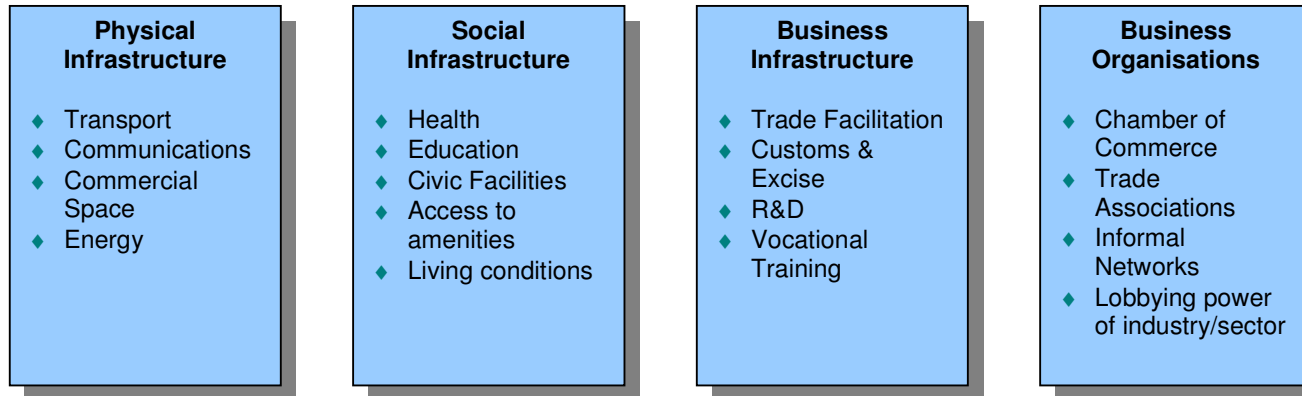
Thus for such investors, having started with the premise that it is desirable to invest and possibly even having the outline of a project, the sequencing is as follows: selecting countries that offer favourable operating environments, as described by the factors listed as macro and meso in figure 1 above; then focusing on the profitability of the project in the country selected and at this stage revisit both risk and tax regimes in detail. Taxation thus may figure prominently in their investment decision.

For the opportunistic investor, analysis focuses on the micro level to begin with. Thus specific tax considerations enter much earlier in the decision making process. Such investors, having identified attractive opportunities, are likely also to consider meso and macro level factors. Macro factors essentially help them evaluate risk. For such investors, tax issues tend to be important, but subsumed in the attractiveness of the project itself.

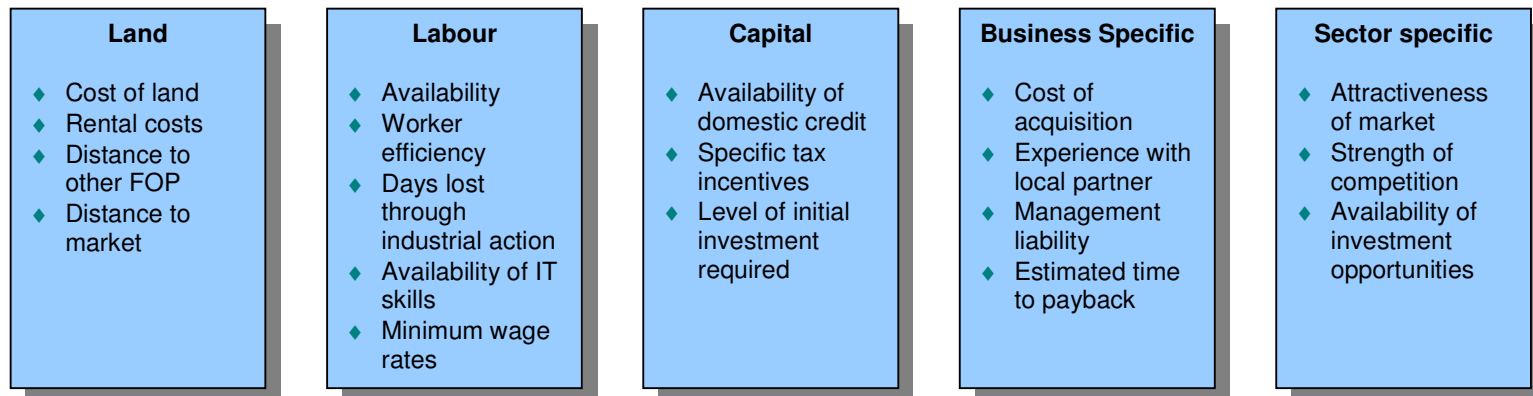
Figure 1: Factors for Choice of Investment Location



MESO LEVEL – Country Short Listing: Transaction Costs



MICRO LEVEL – Final Country/Project Specific Considerations



II. FOREIGN INVESTMENT TRENDS IN CENTRAL AND SOUTH EAST EUROPE

Before analysing the results of the survey, it is important to understand investment trends in South East Europe to set the study in its empirical context. We have used the analysis of trends also to analyse the effect that important factors, such as privatisation, have had on investment during the last decade. Privatisation stands as a proxy for the level of opportunistic investment and the ease of entry for strategic investors into a country. It provides a ready made vehicle for investment. In addition to the South Eastern European countries we have included some Central and Eastern European countries as well for comparative reasons.

2.1. Trends in FDI

Since the process of economic transition began in 1988, FDI inflows into Central and Eastern Europe have increased dramatically, reaching a record level of \$27 billion in 2000. Inflows, however, are concentrated, with two countries (Poland and Czech Republic) receiving two-thirds of the region's total inflows. FDI in South Eastern Europe have also increased dramatically over the period, though falling moderately in 1999 and 2000. South East Europe saw its peak FDI inflows in 1998, reaching almost \$4 billion, although the biggest increase of inflows occurred between 1996 and 1997 when FDI increased almost threefold (figure 3).

Figure 2: FDI flows in Central and Eastern Europe 1988-2000

	1988-1993 (Annual average)	1994	1995	1996	1997	1998	1999	2000
FDI Inflows in Central and Eastern Europe (US\$ million)	3,792	6,200	14,613	13,538	20,806	22,349	25,123	26,815
Czech Republic	502	869	2,562	1,428	1,300	3,718	6,324	4,595
Hungary	1,033	1,146	4,453	2,275	2,173	2,036	1,944	1,957
Poland	478	1875	3,659	4,498	4,908	6,365	7,270	10,000

Source: UNCTAD, World Investment Report 2000 and 2001.

Figure 3: FDI flows in South Eastern Europe 1988-2000

	1988-1993 (Annual average)	1994	1995	1996	1997	1998	1999	2000
FDI Inflows in South Eastern Europe (US\$ million)	282	669	816	1,111	3,144	3,863	3,660	3,435
Albania	39	53	70	90	48	45	41	92
Bosnia & Herzegovina	-	-	-	-2	1	10	90	117
Bulgaria	35	105	90	109	505	537	819	1,002
Croatia	120	117	114	511	540	935	1,474	899
Macedonia	-	24	10	12	16	118	32	170
Moldova	16	28	67	24	79	74	39	128
Romania	72	342	420	265	1,215	2,031	1,041	998
Yugoslavia	95	95	45	102	740	113	124	29

Source: UNCTAD, *World Investment Report 2000 and 2001*.

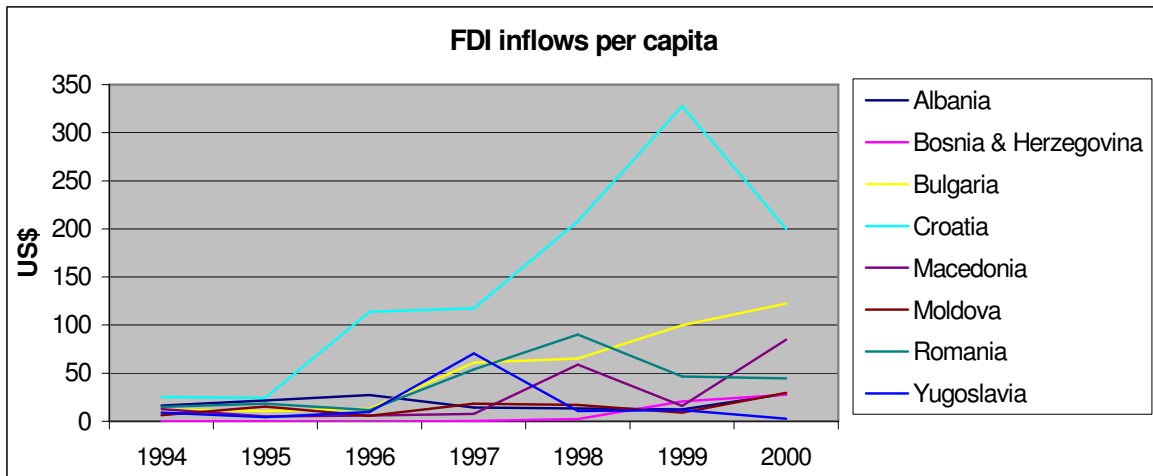
Figure 3 shows that FDI flows in South Eastern Europe are also concentrated. Romania has received the highest share of FDI in the region followed by Croatia and Bulgaria. A reason for these three countries receiving the major share of FDI is the relatively larger size of their economies. As noted earlier, the size of the market is an important factor in location decisions. The large flows into Romania between 1992-1996, comprised a few large investments in the consumer goods industry (Coca-Cola, Colgate-Palmolive) drawn to the country by its large markets.

Thus, in general, the larger economies received the highest FDI flows, with the exception of Yugoslavia. Yugoslavia is the second largest country in the region after Romania, but FDI flows were deterred by the country's involvement in a war that lasted 10 years.

In per capita terms, however, the picture is quite different. Figure 4 below shows FDI per capita in the SEE region. Croatia has received the highest amount of FDI per capita. Larger countries, such as Romania, have received surprisingly low flows of FDI per capita. Thus, with per capita flows standing as a proxy for the overall contribution to the economy, size does not prove to be an overriding determinant of FDI. It influences, but not decisively, a country's ability to attract FDI. Slovakia, for example, a country of 5.4 million people, attracted around \$2,000 million of foreign investment in 2000 compared to Romania (22.3 million people) which received half

of that amount. To explain FDI inflows into Central and Eastern Europe, it is necessary to consider other factors such as privatisation, tax and political stability.

Figure 4



Source: UNCTAD, World Investment Report 2000 and 2001; EBRD Transition Report 2000.

2.2. The role of Privatisation

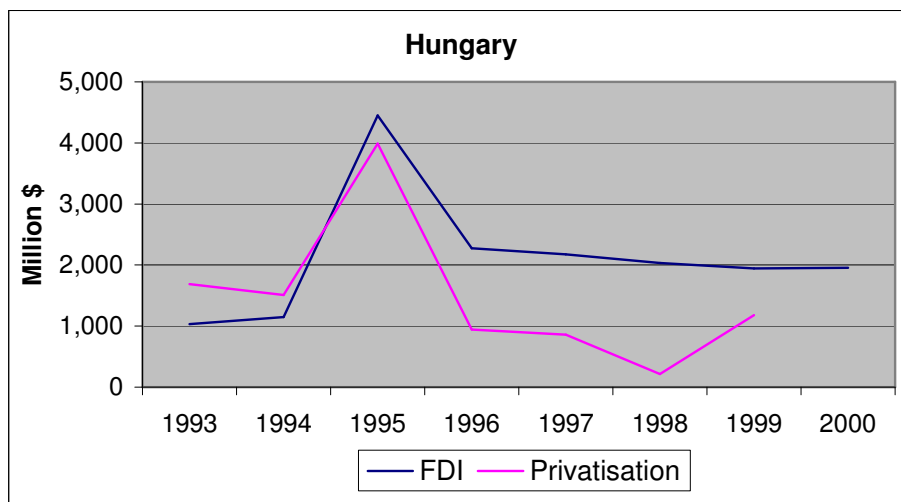
Privatisation-related FDI transactions are a key determinant of FDI inflows in Central and Eastern Europe. Privatisation opportunities may be particularly effective at triggering FDI inflows in the early stages of transition. While operating conditions may be less than ideal, the ability to acquire strategic assets at low costs serves as a strong motive to counter the greater risk. Further, privatisation provides a ready made investment vehicle and offers considerable first mover advantages since it allows enterprises to secure market shares while pre-empting competitors from doing likewise.¹⁶ It offers advantages to both the strategic and opportunistic investor.

FDI inflows into the Czech Republic were relatively low up until 1995, reaching an annual average of \$563 million, but then increased dramatically to \$2,562 million in 1995. In subsequent years, FDI has continued to flow into the, reaching an all time high of \$6,324 million in 1999. This sudden change in the level of FDI inflows was due to the fact that the privatisation policies during the first half of the 1990s excluded foreign participation in the Czech Republic, and from 1995, the second round of privatisation followed the example of other countries such as Hungary, which had successfully involved foreign firms.

¹⁶ EBRD Transition Report 1994

Hungary was the first country in the region to receive significant inflows of FDI mainly because of its openness to foreign investors through the privatisation program. In 1995, there was a strong increase in inflows into Hungary because of major privatisations in infrastructure. As a result, Hungary experienced its peak of FDI in that year, reaching \$ 4,453 million, with privatisations accounting for almost 90%. From the mid-1990s onwards, the FDI inflow has been less as major privatisation deals have been completed.

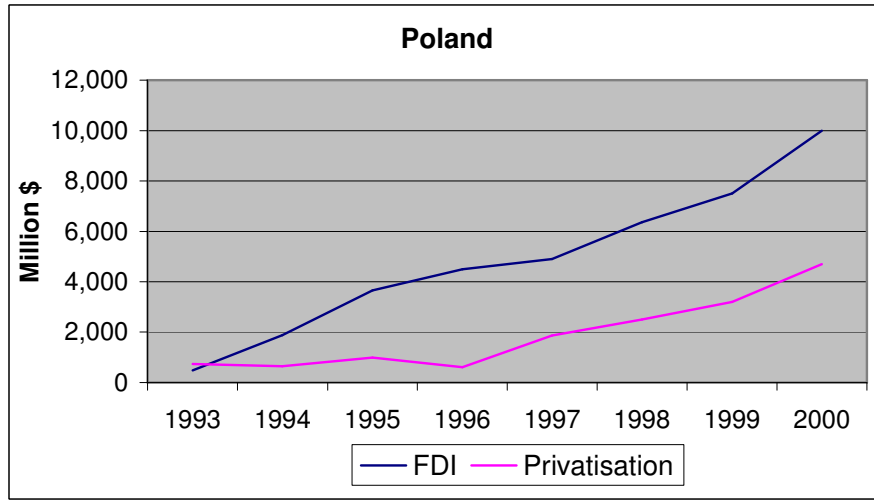
Figure 5



Source: UNCTAD, *World Investment Report 2000, 2001*; *World Bank PSD Yearbook*; *World Bank Privatisation Transaction Data 1988-1999*.

Poland has shown a gradual and consistent increase in FDI throughout the years. FDI rose particularly sharply in 1995 as a result of the long delayed voucher privatisation program getting under way. FDI inflows more than doubled in that year, reaching \$3,659 million. Privatisation proceeds have continued to grow and have averaged between 40%-50% of total foreign investment. Almost 50% of the total FDI inflows in 1999 came from banking sector privatisation.

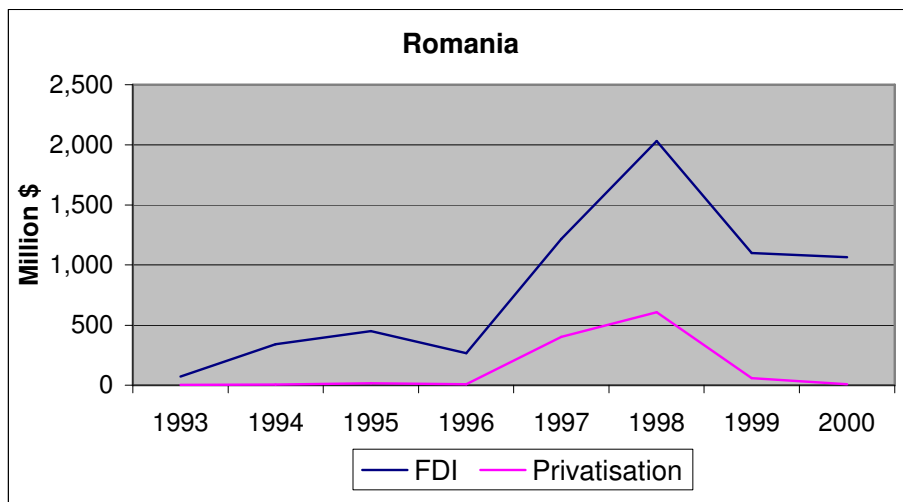
Figure 6



Source: UNCTAD, *World Investment Report 2000, 2001*; *World Bank PSD Yearbook*; *World Bank Privatisation Transaction Data 1988-1999*.

During the period 1991 – 1996, privatisation opportunities in Romania were very limited and did not include public utilities or banks. Due to this, FDI inflows during that period averaged around \$300 million a year. During 1997 – 2000, on the other hand, the legal and institutional framework for investment became extremely volatile and unpredictable, but privatisation offers increased considerably. As a result, FDI increased almost five-fold in 1997 to \$1,215 million, reaching a peak in 1998 of \$2,031 million.

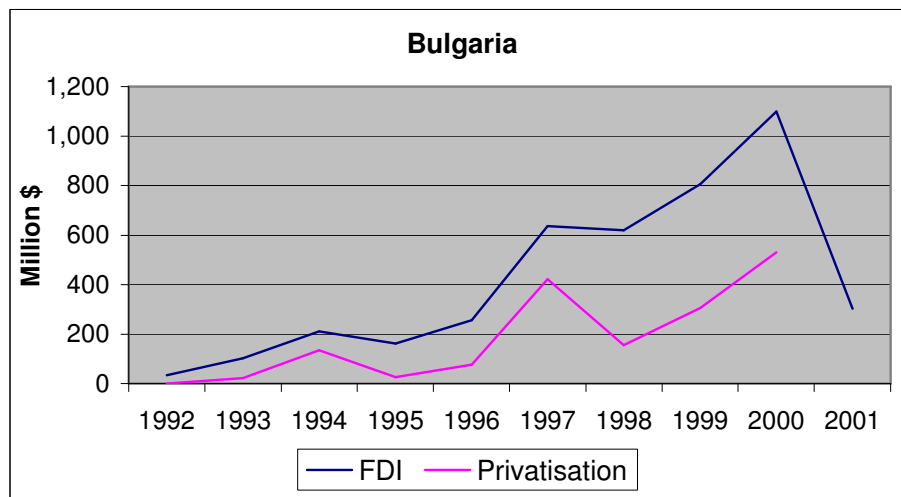
Figure 7



Source: UNCTAD, *World Investment Report 2000, 2001*; www.investromania.ro

The privatisation process in Bulgaria began in 1992. In theory, foreign investors were allowed to be involved in a privatisation on equal terms with locals. In reality, however, foreign investment was beset with numerous difficulties. The process of privatisation proceeded slowly. In June 1994, Bulgaria began its long delayed mass privatisation through vouchers but FDI inflows still averaged only \$86 million per year. This low figure is partly explained by the fact that, at this time, Bulgaria largely excluded “strategic” sectors, such as energy, telecoms and other public utilities from privatisation. In 1997, following parliamentary elections, privatisation of state owned enterprises became more open and attractive to foreign investors. As a result, FDI into the country increased sharply, reaching \$505 million that year, and continued to increase over the years, reaching a high of \$1,073 million in 2000. A large percentage of this rise in FDI inflows was privatisation-related.

Figure 8

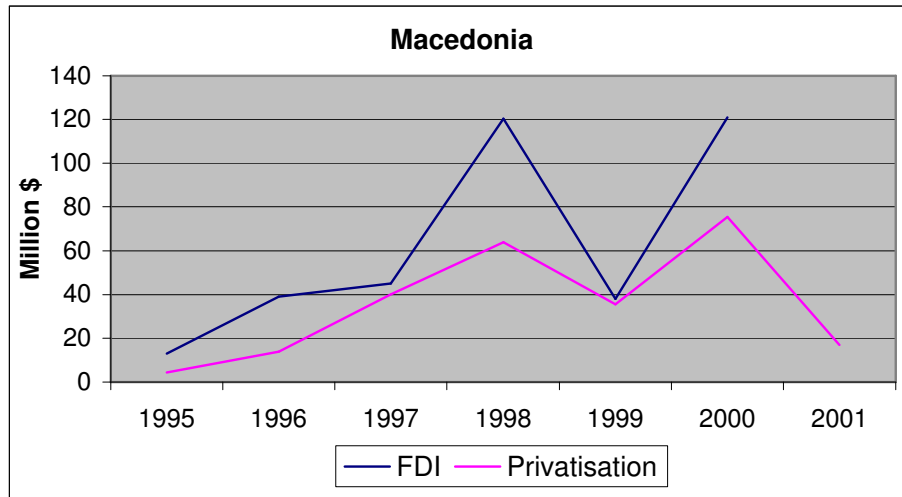


Source: Bulgarian Foreign Investment Agency.

Macedonia has had a relatively poor record at attracting direct investment from foreign investors. In the early years of its transition, most privatisation was in the form of employee or management buy-outs. The law initially excluded the privatisation of utilities and the transport system. As a result, FDI into the country averaged only \$30.25 million until 1997. It is clear from figure 9 below that a large proportion of this was due to privatisation. During this time, foreign investors were deterred also by high political risk in the region. Their participation in the privatisation process amounted to less than 2% of equity privatised. The situation improved

sharply in 1998 facilitated by an improved economic climate. In addition, the government began preparing international tenders for stakes in telecoms, energy and the oil refinery. This resulted in a sharp increase in FDI in 1998 amounting to \$120.3 million.

Figure 9



Source: UNCTAD, World Investment Report 2000, 2001; Macedonian Privatisation Agency.

In recent years, in many South Eastern European countries, bank privatisation has been one of the main driving forces behind FDI inflows, and the share of the banking sector in FDI has increased substantially. Bulbank in Bulgaria was acquired by Unicredito from Italy in late 2000, the National Bank of Greece took over Stopanska Banka in Macedonia in the spring of 2000, and in 1999 the Romanian Development Bank was bought by Societe Generale.

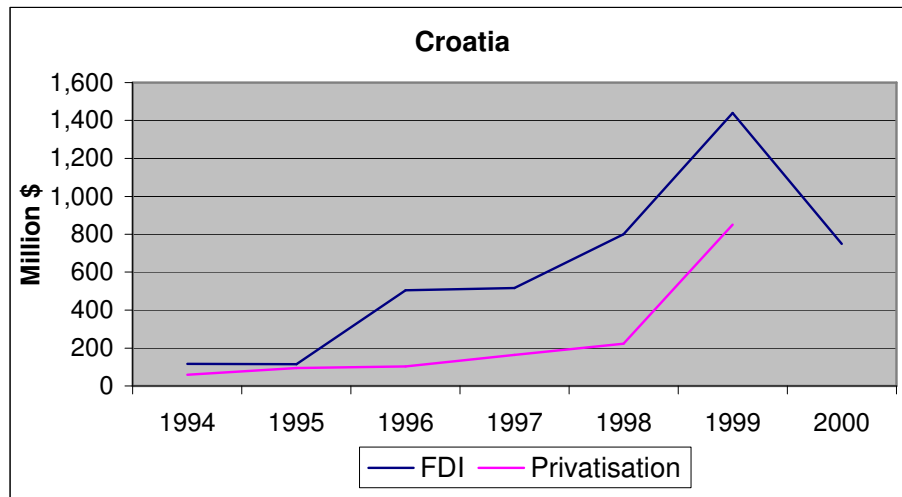
2.3. Political Stability

The political stability of a country can exert major influence on investors when making a decision about where to invest. The evolution of foreign direct investments in Romania can be linked to the two election cycles: 1992 – 1996 and 1997 – 2000. During the period of 1991 – 1996 there was a stable, even attractive legal framework for foreign direct investment in Romania. During this period, foreign investors were offered greater incentives than local investors. In addition, the level of corruption and the level of bureaucracy were not very high. All of this brought about a large influx of investors into Romania, though all were relatively small, the majority being individuals not companies. During 1997-2000, as stated above, the investment

environment became volatile and unpredictable and not really suitable for small investors, and FDI fell off after 1998.

Foreign Direct Investment has been slow to arrive in Croatia. The lag may be explained by political instability of the last decade, resulting from the war, as well as the policies of the previous regime. The former regime under Franjo Tudjman went out of its way to obstruct foreign investors and award the spoils of industry to political cronies. As a result, in the first half of the 1990s, FDI into the country was very low. In contrast, since coming to power in January 2000, the current government has taken active measures to welcome foreign investors, expedite privatisation of the state monopolies, and improve the Croatian business environment.

Figure 10



Source: UNCTAD, *World Investment Report 2000, 2001*; *World Bank PSD Yearbook*; *World Bank Privatisation Transaction Data 1988-1999*.

The war in Bosnia & Herzegovina completely deterred FDI activity into the country until 1998 when FDI started to flow. But levels of FDI are still insignificant. Similarly, in 1999, there was a sharp contraction of FDI inflows into Macedonia because of the Kosovo conflict. Several planned deals were postponed because of the deterioration in the investment climate and increased investor caution in the region resulting from the Kosovo crisis. Flows into the country fell 73% that year but picked up again in 2000 on the back of renewed stability in the region, and following recent amendments to the privatisation law that facilitate foreign investment.

The conclusion is that without a basic level of political stability, foreign investors are not likely to invest in a country. Further, political stability, if accompanied by favourable policy changes, is likely to cause FDI inflows to increase.

2.4. Sector Trends

Internationally, some industries are more global than others and so the sectoral composition of the economy could have an impact on the rate of FDI in a country. We therefore analysed the sectoral composition of FDI flows into SEE countries.

Manufacturing was initially the single largest host sector in the region, accounting for 40-60% of FDI (see figure 11 below). Within manufacturing, industries such as food and beverages, chemicals, electrical machinery and vehicle manufacturing play an important role in FDI, as they do world wide.

However, FDI into the services sector is becoming increasingly important as a result of liberalisation and privatisation of financial services, telecommunications and electricity distribution. In 1999 the share of services increased at the expense of manufacturing reaching about 56%. Overall, this analysis points to the importance of the privatisation process rather than the sectoral composition of the economy as shaping the composition of FDI flows into SEE countries. In a globalising world, what appears to matter is the opportunities provided to investors rather than the initial composition of the stock of assets.

Figure 11: Sectoral distribution of inward FDI stock (%) (Latest data available)	Albania December 1995	Bosnia and Herzegovina July 1998	Bulgaria December 1998	Croatia December 1999	Czech Republic December 1998	Hungary December 1998	Macedonia December 1998	Moldova June 1998	Poland December 1999	Romania December 1999
Primary Sector	1.4		1.6	3.4	1	1.4			0.3	3
Agriculture, hunting, forestry and fishing	1.4		0.2		0.2	0.9			0.1	3
Mining, quarrying, petroleum and gas			1.4	3.4	0.9	0.5			0.2	
Secondary Sector	17.1	32.7	49.4	41.1	45.8	37.3	91.2	33	49.2	43.8
Food, beverages and tobacco			21.5	4.2	7.1	9	25.8		13.1	13.9
Textiles and apparel			1		1.6	1.6	2.2		0.7	3.5
Wood, furniture, paper, publishing and printing			2.1		4.8	1.8	0.3		5.7	
Coke and petroleum products				1.5	1.6		20.9			
Chemicals and Chemical products			4.6	24.9	2.4	8.9			3.7	
Rubber and plastic products			0.5		2.3				1.3	
Non-metallic mineral products				7.8	9.5	2.3	21.2		5.9	
Basic metals and products			8.4		3.4	3	20.6		1.1	
Machinery and equipment					1.5	10.3	0.2		1.5	26.4
Electrical machinery and apparatus			1.3	2.7	4.5				3.6	
Motor vehicles and other transport equipment			0.9		7				12.5	
Other manufacturing and recycling					0.1	0.3				
Tertiary Sector	81.5	62.7	49	44.2	53.2	61.4	8.8	56	50.5	53.1
Electricity, gas, steam and water supply					4.7	17.3		36	1.3	
Construction	5.1	10.3	1.3	1.2	1	1.6			5.5	2.3
Wholesale, retail trade and repair of motor vehicle	65.8	25.7	23	1.6	17.3	10.6	7	20	9.7	24.1
Hotels and restaurants			2.1		0.1	1.8			1.2	0.8
Transport, storage and communication	4.6	6.2	5	30.6	9.2	8.2	1.9		5.4	2.3
Financial intermediation			11.4		14.8	10.9			22.4	
Real estate, renting and business activities			5.4	10.8	5.5	9.4			0.5	
Public administration, health and social services					0.5	0.1			4.5	
Other community, social and personal service							1.4			
Unspecified services	5.9	20.5	0.8		0.1					23.6
Unspecified		4.6		11.3				11		
Total	100	100	100	100	100	100	100	100	100	100

Source: UNCTAD, World Investment Report 2000

2.5. Conclusions

In the past, privatisation has been the major determinant of FDI inflows into the South East European region. Political stability and the economic environment have had an effect on FDI flows, but the correlation of FDI with privatisation remains the single most decisive result of the analysis above. After 2002, however, in the economies most advanced in the transition process, the large majority of assets in value terms would already have been privatised. In the post privatisation era the key issue will be how to attract FDI into green-field ventures and into privately owned assets.

The above analysis shows that in countries that have sustained high and growing rates of FDI, such as Poland, the gap between inflows from privatisation and total FDI has increased. These countries have succeeded in capitalising on the band wagon effect of FDI started by privatisation. In general, they have been able to establish a liberal regime for FDI and subsequently, also addressed taxation.

Studies suggest that the decisive factor of FDI regimes in SEE countries is, in fact, political, legal and regulatory support to FDI. Foreign investors stress the problem of government behaviour and legal inflexibility which hinders the entry of foreign capital, or which discriminates in favour of domestic investors.¹⁷ This environment turns away foreign investors who are not used to such discrimination or other discouraging treatment in their own economies. It increases the perceived risk of domestic businesses being given preferential treatment and even of expropriation of foreign owned assets. In the post privatisation era, SEE countries wishing to attract FDI need to focus on removing any remaining discrimination against and other impediments to foreign investors if they wish to compete seriously for FDI flows into the region.

¹⁷ Croatia's Position Among Transition Economies Based On The Analysis Of The Balances Of Payments, Iris Čokljat

III. SURVEY RESULTS

3.1. Overview

The investor survey was designed to gain insight into the actual decision making process that investors go through when investing in South East Europe. It is the main foundation of this report and provides perspectives on the way the operating environment and investor motivation impact location choice, highlighting the relative importance of taxation factors in the decision making process.

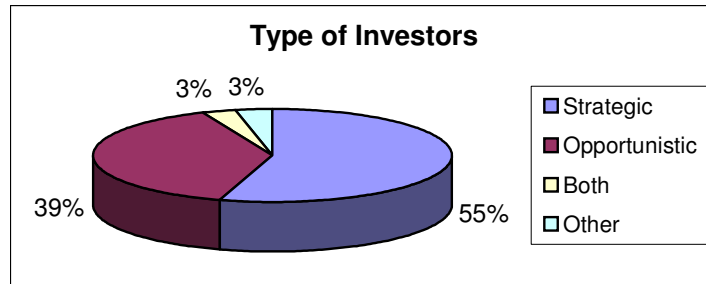
The survey instrument was a questionnaire designed in collaboration with the OECD. It is included as Appendix I of this report. The survey covered the following elements:

- **Background** – Providing background to the investor’s business and specifically their presence in South East Europe. It includes questions on the size of the investment and the sector in which the company invested.
- **The Decision Making Process** – Understanding the approach and process followed by investors to undertake their investment in South East Europe. It seeks to differentiate between the two types of investors (strategic and opportunistic) and to identify the key determinants of the business opportunity for each type of investor.
- **Importance of Key Indicators** – Identifying individual factors that were considered in the investment decision and the factors that were major impediments to investment in the region.
- **Specific Taxation Factors** – Indicating the tax considerations that were considered to be important to the investment decision by each type of investor.

The investor survey was sent to over 300 companies who have invested, had considered investing or were currently undertaking an investment appraisal process in South East Europe. Efforts were made to ensure that the origins of the companies were diverse, and the business sectors of their company was also reflective of the breadth of recent foreign investment flows into the region. The investors come from 20 different countries around the world, including UK, Germany, France and the US. Our return rate was 10% (i.e. we received 31 surveys back), which is a good rate of return on this kind of survey (EBRD had only 5% return rate on a similar survey). Out

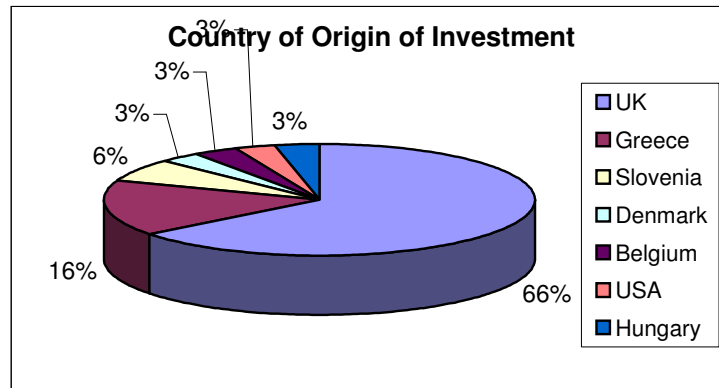
of the 31 responses that we received, 17 of the investors were strategic (investment decision was generated from the overall business strategy of the company), 12 were opportunistic (investment was primarily based on identification of specific business opportunity), 1 was both strategic and opportunistic and 1 was other (general interest in a specific sector). The reason why more strategic investors than opportunistic ones responded is unclear.

Figure 12



The country of origin of the investors was varied from developed to developing countries, but the majority came from the UK (66%). This by no means indicates that UK is the largest investor in the South Eastern European region, and is likely to be due to sample bias.

Figure 13



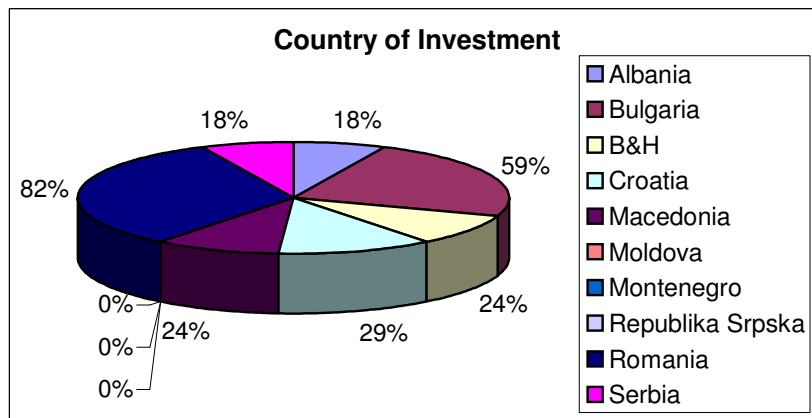
The investors that responded to our survey came from such a wide variety of sectors that it has not been possible to correlate responses with the country of origin of the respondent.

3.2. Profile of Companies

Strategic Investors

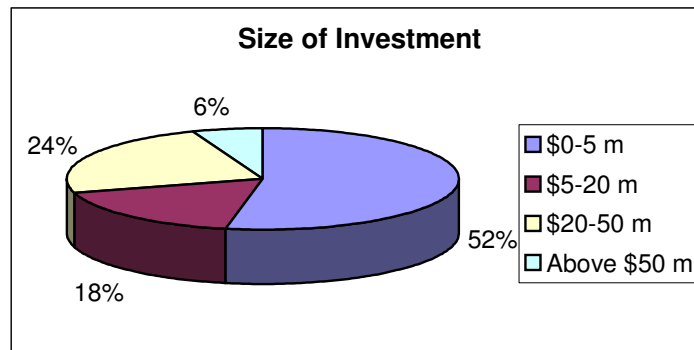
Most of the strategic investors (82%) that responded to our survey had invested in one, two or three countries in the South East European region. Only a few have invested in more countries in the region. The majority of these investors have invested in Romania (82%). The second favourite country for foreign investors in the region is Bulgaria (59%) followed by Croatia (29%). This has come as no surprise as these three countries are the furthest in the transition process in the region and attract the highest share of FDI (see figure 3 above).

Figure 14



The size of the investment was mostly between \$0 - \$5 million with 30% exceeding \$20 million.

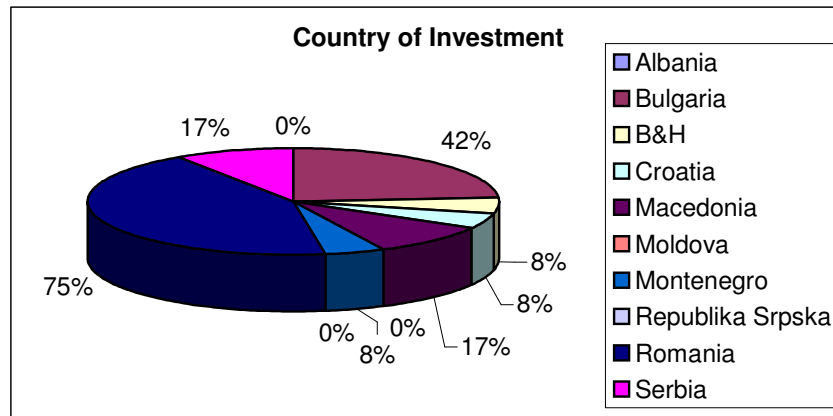
Figure 15



Opportunistic

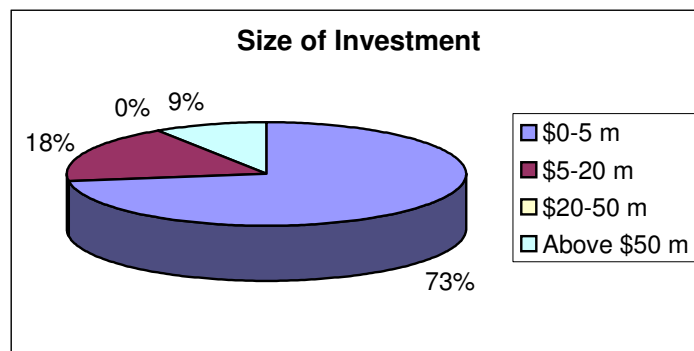
Most opportunistic investors invested in only one or two countries in the region. They were, by definition, prompted by specific opportunities rather than the attractiveness of the region as a whole. Again the favourite country for investment was Romania (75%) followed by Bulgaria (42%) confirming the link with privatisation and the fact that more developed countries have a more stable investment environment and therefore receive more FDI than less developed countries. Countries such as Albania and Moldova do not appear to be very attractive to foreign investors.

Figure 16



As with strategic investors, the majority of investors (73%) invested up to \$5 million with only few investments above \$50 million. It can be noted though that strategic investors have invested on average more money in the region than opportunistic investors have. The reason for this could be that strategic investors are usually big multinational companies who are investing in the region for the long run as opposed to the opportunistic investors who focus on specific opportunities.

Figure 17

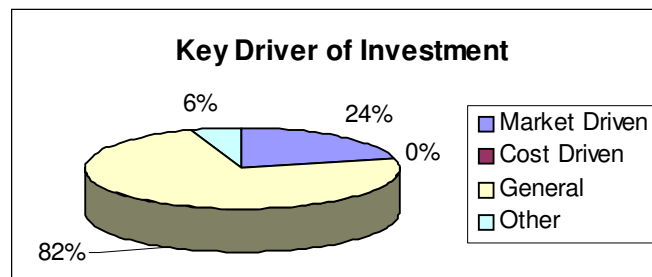


3.3. Decision making process - Key Factors

Strategic

The key driver of investment in the South East European region for the strategic investors was general strategic i.e. the basis of investment decision was wider than the investment itself and investors sought to obtain long-term competitive advantage. 24% of investors were market driven, attracted by the opportunity to sell existing products in a new market. No investor made an investment in the region for the purpose of utilising the cost advantages (such as cheap labour) that operating in this region would bring.

Figure 18

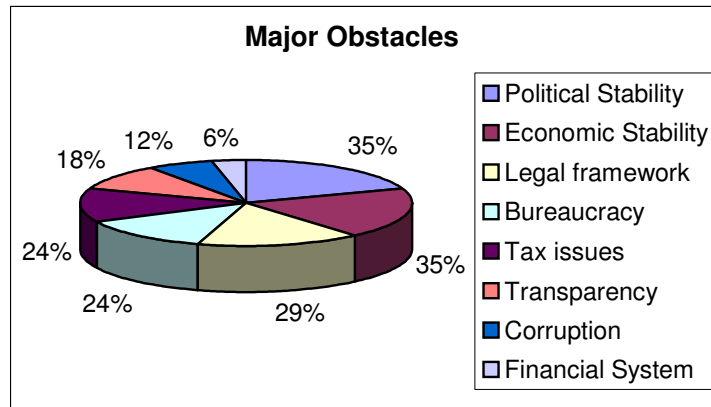


This again reinforces the fact that for strategic investors, the investment decision process is part of the company's overall strategy and that planning horizons are long-term.

When analysing investment opportunities in the South East European region, the strategic investors largely viewed political instability (35% of respondents) and economic instability (35%) of a country as major obstacles to their investment. The legal framework (25%), bureaucracy (24%) and tax issues (24%) were also considered to be important in the decision making process. The reason why these factors are considered to be so important by strategic investors, especially tax issues and the legal framework, is that these companies are selecting between countries in the region. They look, therefore, to locate in operating environments in which perceived risks (influenced by taxation) are lower. Importantly, investors noted that what concerns them the most is the instability and unpredictability of these factors. That is, uncertainty over tax policy and administration, rather than a concern over the effective corporate tax rate, was found to be an important impediment by investors.

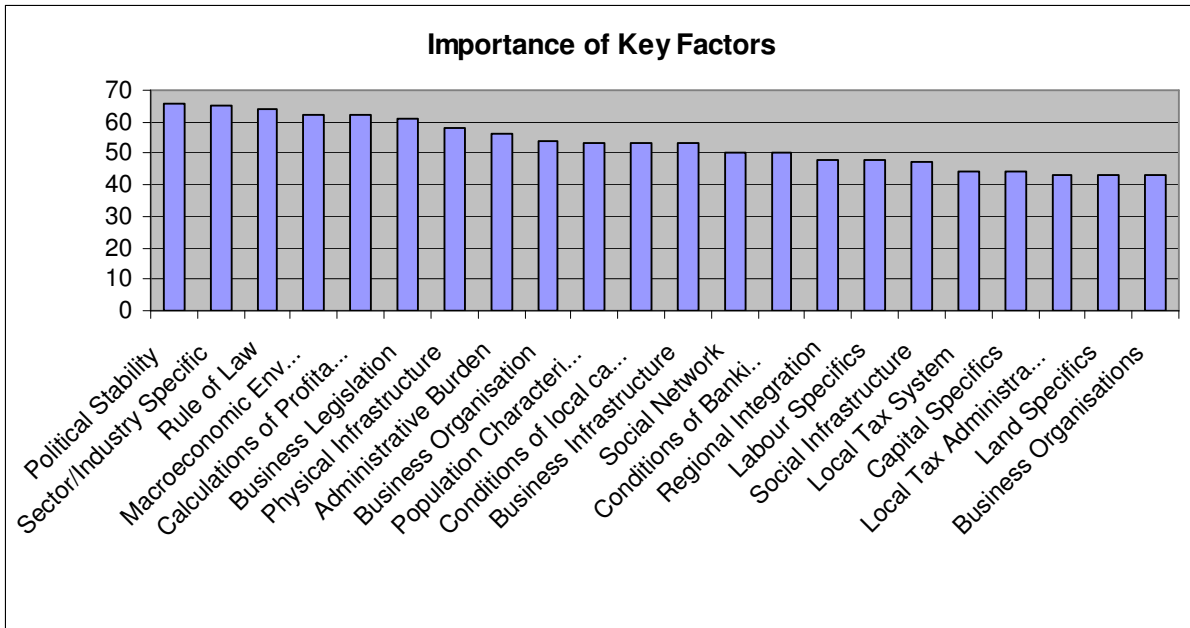
The tax system and the legal framework are so volatile in some countries that investors can't foresee what is going to happen in the future, so they adjust projected earnings downwards to take account of these risks.

Figure 19



When asked to indicate the relative importance of a number of indicators in the investment decision making process, strategic investors rated political instability the highest. Apart from political stability, sector and industry specific factors, rule of law and macroeconomic environment were also considered to be important. The local tax system and the local tax administration did not seem to be as important in the decision making process as other factors. They were taken into consideration in the investment decision process but they were not considered to be critical.

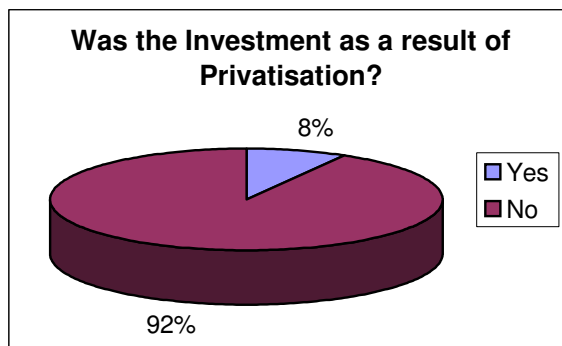
Figure 20



Opportunistic

Only one opportunistic investor invested in the region as a result of a privatisation process. All others were investments resulting from being made aware of a specific business opportunity by advisors or other contacts. The reason for this could be that most of these investments were recent and in most countries in the region the privatisation process is nearing completion. This result shows that though privatisation is an excellent way of publicising opportunities, its place can and, in the future, must be taken over by other channels of information flow such as professional advisors.

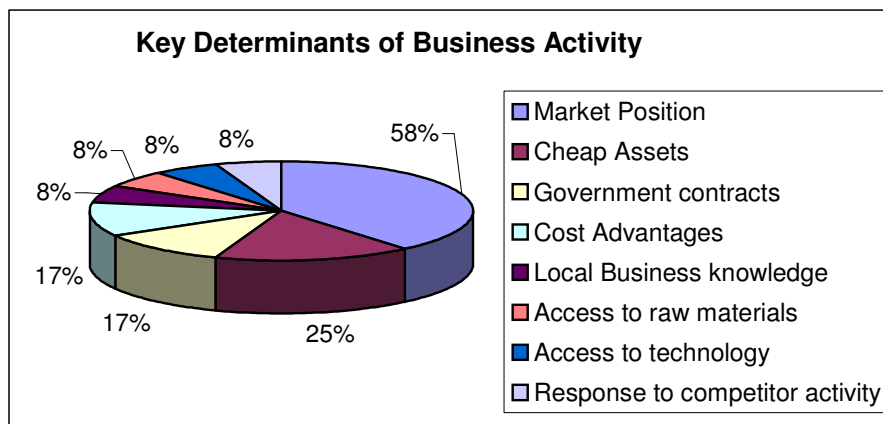
Figure 21



The key determinant that led these opportunistic investors to invest in the South East European region was market position in the country or the region. The availability of

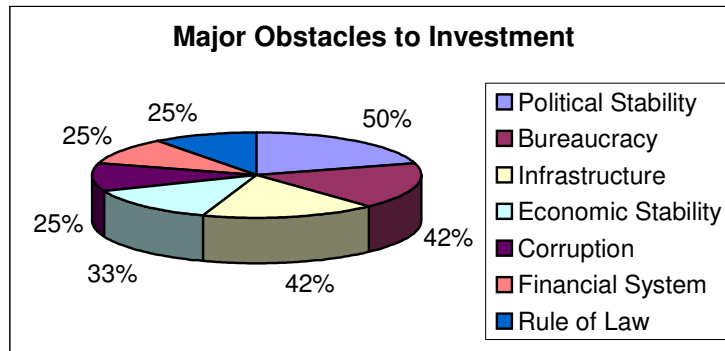
cheap assets, government contracts and cost advantages were also considered to be important by such investors, not because expected profit margins were thin, but because these largely underpinned large expected profits. This again confirms the distinction between the strategic and opportunistic investor and the different process they go through when evaluating an investment. The opportunistic investor is more concerned about the profitability of the opportunity at hand.

Figure 22



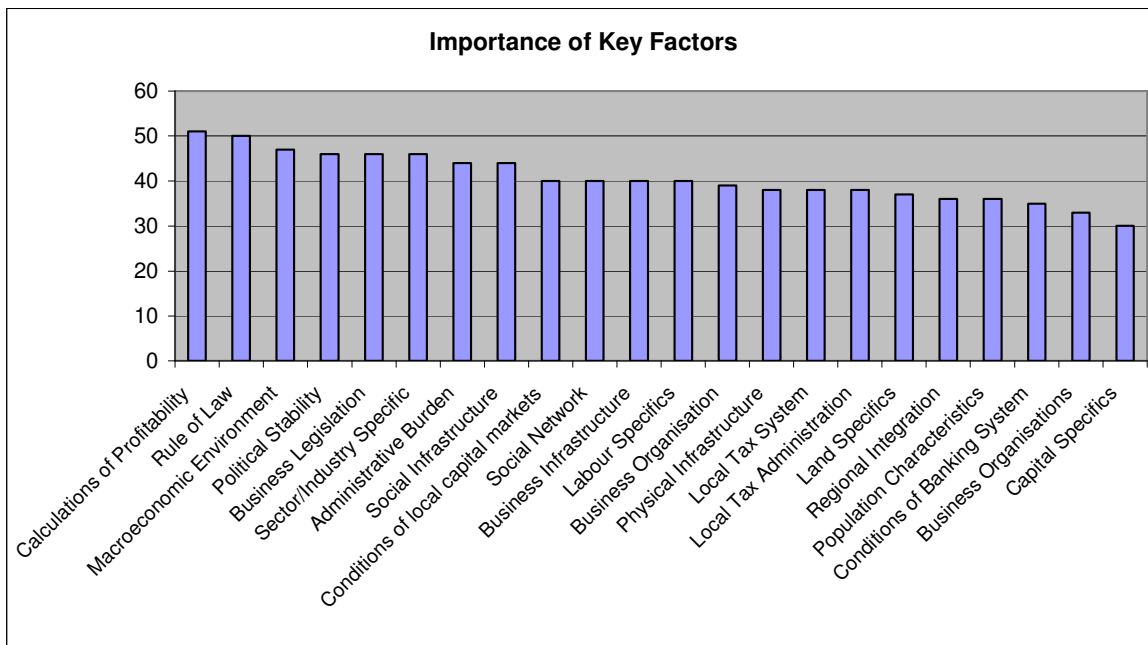
Political instability was again viewed to be the major obstacle to investment in the region when analysing opportunities. Bureaucracy, inadequate infrastructure and economic instability were also seen as negative factors. Tax issues were not mentioned in the responses of the opportunistic investors, indicating that they were not so important in the decision making process. The reason for this is that these investors are investing because of a specific opportunity that they have identified and tax factors may not be considered to be critical provided the returns to the opportunity are high.

Figure 23



The majority of the opportunistic investors considered the calculation of profitability and the rule of law to be critical in the investment decision process. Other factors considered important include macroeconomic environment, political stability, business legislation and sector and industry specific factors. The local tax system and the local tax administration were considered important but not as important in the decision making process of these investors as the factors above.

Figure 24



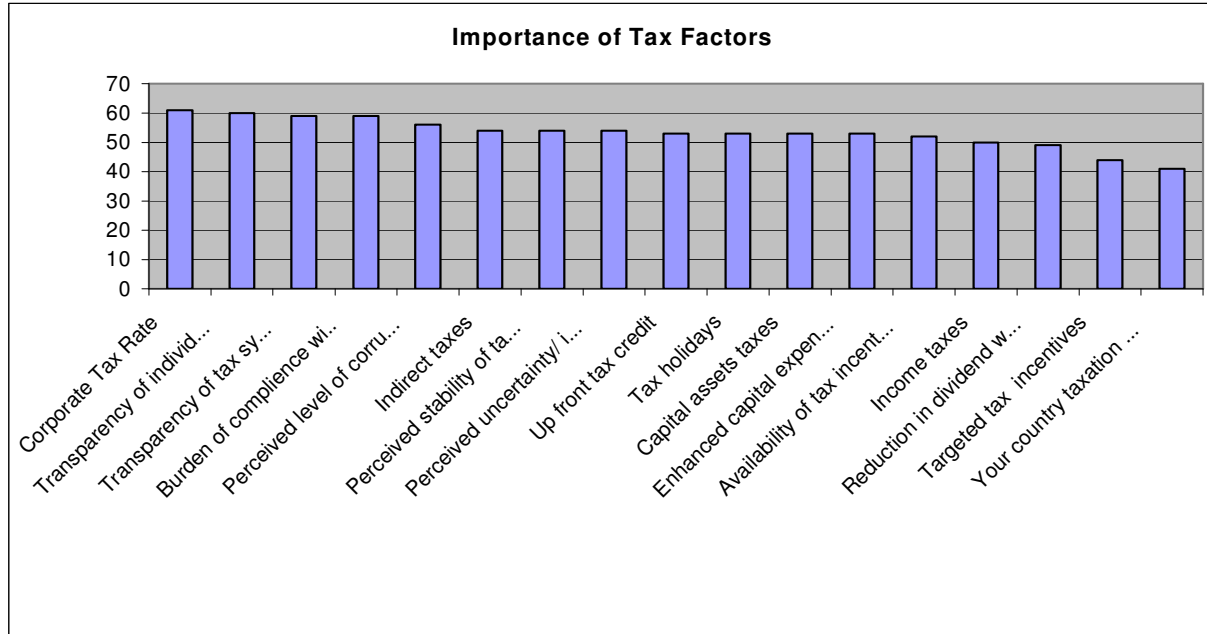
3.4. The Importance of Tax Incentives

Strategic

44% of strategic investors rated tax factors as being critical in their investment decision process (as shown in figure 25 below). Among tax considerations, the rate

of corporate tax scored the highest, followed by the transparency of the individual company tax calculation, the transparency of the tax system, and the burden of compliance with tax rules. Targeted tax incentives and the company's country taxation system were not considered as critical as other factors.

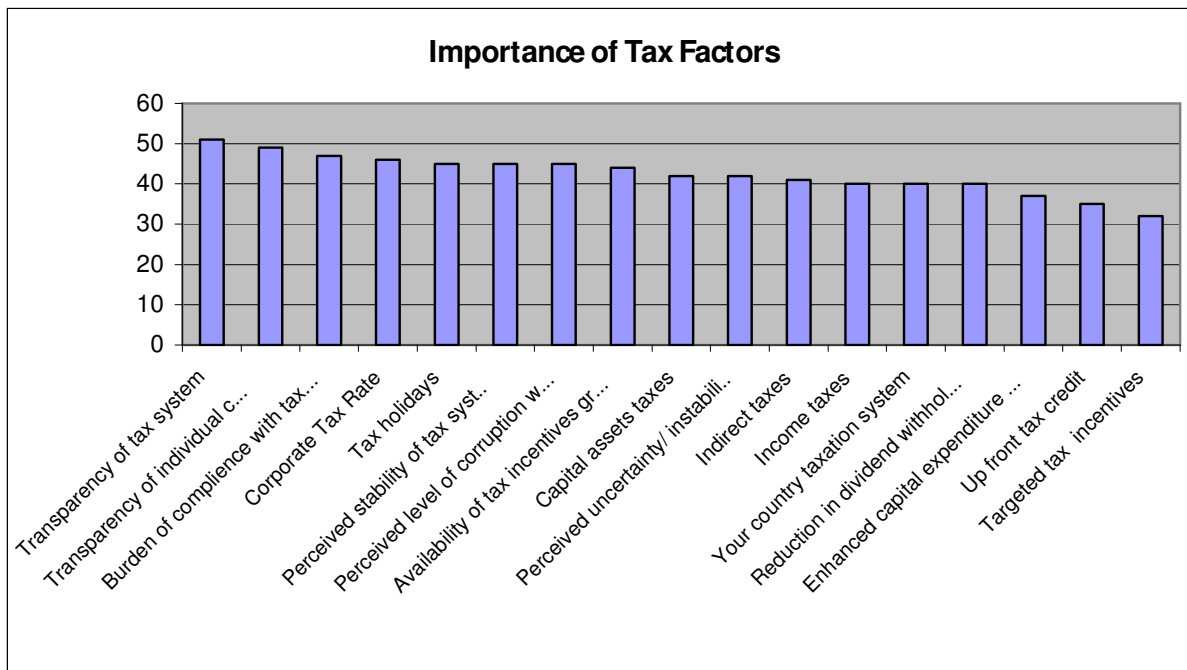
Figure 25



Opportunistic

34% of the opportunistic investors considered tax factors as critical in their investment decision, significantly less than strategic investors. These investors viewed the transparency of the tax system to be the most important factor, followed closely by the transparency of the individual company tax calculation and the burden of compliance with tax rules. Up front tax credits and targeted tax incentives were not considered as critical to the investment decision.

Figure 26



Tax is an important factor for both types of investors, but for the strategic investor, it is more likely to be relevant to the investment decision.

3.5. Conclusion

Tax issues appear to be of greater importance for strategic investors, specifically the stability and the predictability of the tax system. This is because strategic investors select from a number of countries in the region to find the least risky environment. Opportunistic investors, on the other hand, are concerned about tax issues but are more interested in the level of net returns to the project. In general, though, taxes do not appear to have great importance in the decision making process of an investor. Other factors, such as the political and economic stability, seem to be much more important when it comes to deciding in which country a company should invest. Indirect taxation appears to have least importance for foreign investors.

IV. CASE STUDIES FROM INVESTOR SURVEY

The overall results from the investor survey reflect the wide range of investors that have recently invested, had considered investing or were currently undertaking the investment appraisal process in South East Europe. Their sector of activity, motivation and level of investment varied considerably.

Within the questionnaires received by **eme**, responses to the taxation section of the survey were the most varied in terms of detail and level of completion. Some answers were limited with the rest of the survey being completed satisfactorily, while other respondents replied at length on the role of taxation within the investment decision.

We attempted to cover some of the gaps in responses on taxation issues. In the majority of cases where the respondent was contacted to clarify taxation responses, explanations for the section not being fully completed was because taxation factors were not important or not considered to a high degree of detail within the investment making process. This simple fact highlights the general insight based on responses to the investor survey – *that many investors felt unable to answer the detailed questions on taxation because taxation did not factor heavily in their investment decision process.*

In addition to covering gaps in the information, we were concerned also to understand better the motivation of respondents and the underlying causes of their responses. We therefore carried out follow-up interviews with a selected group of respondents to prepare brief case studies.

Five case studies are therefore examined below - three strategic investors, an investor with a mixed strategic-opportunistic profile, and one opportunistic investor:

1. International Company in Romania in the oil, gas and mining sector
2. Food and Beverage Company in Macedonia
3. Health Provider company in Bosnia-Herzegovina
4. International Manufacturing Company in Romania
5. Manufacturing Company in Bulgaria

The case studies in this section help us to put the influence of taxation factors into perspective.

4.1. Case Study One

Company profile:	International oil, gas and mining Company
Country of Investment:	Romania
Size of Investment:	0-5 \$ USD million
Type of Investment:	Strategic

Background

The company is currently withdrawing from its initial investment in Romania. This is due to a number of commercial factors, but include the fact that promised law amendments did not materialise. Other locations of investment in South East Europe by the respondent company included Bulgaria and Macedonia. The company is still actively monitoring investment opportunities in Bulgaria and Romania.

Investment decision Process

Due to the capital-intensive and long-term nature of the proposed investment, factors such as political stability, business legislation and social network were considered important to the investment decision. Sector specific factors such as royalties were deemed critical to the investment process. Less critical factors were business organisations, labour specifics, and physical infrastructure and population characteristics.

When compared with other global investment locations, Romania was perceived to be similar to other locations – there were no important positive or negative characteristics relating to their investment in the country.

Influence of Taxation Issues

The company did consider the overall transparency of the tax system and clarity of individual company tax burdens highly critical to the investment decision – with the highest score in terms of importance to the investment decision. The taxation structure of royalties was also considered highly critical and was highlighted as an additional factor by the respondent. Also considered important was the corporate tax rate, indirect taxes, income taxes and up front tax credits. Factors such as enhanced capital write-offs and targeted tax incentives were not considered within the investment decision process.

The company attempted to negotiate tax incentives with the host government. This was one of only two companies out of the survey respondents who attempted to do so in South East Europe. The results of these negotiations were unsuccessful, though the respondent cited these as not critical to the investment decision. The respondent cited broader issues such as the overall transparency of the taxation system and mining laws to be the major obstacles to the proposed investment. The taxation of royalties was also found to be inconsistent with international norms and therefore to be a negative influence on the investment decision.

The company withdrew from the country in question but remains an active investor in the region through its operations in Bulgaria. The respondent stated that, as reflects their long-term business model, the company continues to appraise the investment environment in Romania and the South East European region.

This company was one of the larger and more international organisations to respond to the survey. Reflecting this, the response indicated a sophisticated strategic process was undertaken in the assessment of country attractiveness. The nature of the sector necessitated a high degree of importance on royalties and importance on the overall investment climate due to the high capital requirements for investment. As noted in the survey results above, this strategic investor included taxation as a

factor in selecting countries for investment. However, the transparency of the system was considered more important than the rate of taxation (apart from royalties). Thus what mattered was the level of taxes specific to the business (on royalties) and the predictability of the tax regime.

4.2 Case Study Two

Company profile:	Food and Beverage company
Country of Investment:	Macedonia
Size of Investment:	3-5 \$USD million
Type of Investment:	Strategic

Background

The company made a strategic investment in Macedonia, where the investment decision was based on factors other than the returns from the project. The investment was therefore a general strategic investment decision, as defined by the investor survey.

The respondent stated Macedonia was selected because of the growth and potential volume of the market, and its strategic location in the region. Other Republics of the Former Yugoslavia were also considered as a destination for investment before Macedonia was selected.

Investment decision Process

Highly critical factors in the investment decision were macroeconomic environment, business legislation, rule of law, physical social and business infrastructure, land cost and availability, and calculations of profitability. Other important factors included political stability, regional integration, population characteristics, business organisations, labour and capital availability and cost, conditions of the banking system and sector specific factors. Local tax system and local tax administration both scored the lowest out of the indicators at four out of five (one being highly critical and five not being considered), and were the only indicators that scored this low.

The respondent identified a number of negative factors in the South East European countries that were viewed as obstacles to investment. For each negative factor identified, the respondent referred to specific countries that reflected these characteristics. Most critical was macroeconomic stability (Croatia, Serbia, Montenegro), followed by political stability (Republics of former Yugoslavia), rule of law (Serbia, Montenegro and Bosnia) and business infrastructure (Serbia, Montenegro and Bosnia). None of these factors, however, were considered important enough to dissuade the company from investing in the region.

Fundamental benefits of investing in the region as well as countries that had these traits were identified. The most important perceived benefits were cheap assets (Former Republics of Yugoslavia), market position in the country (Macedonia), cost advantages (Former Republics of Yugoslavia), access to other resources (Serbia, Macedonia) and high potential of market growth (Former Republics of Yugoslavia).

The respondent highlighted local tax administration and local tax system as being factors that the company should have considered during the investment process but were ignored or the company was unaware of. This was because in practice, they resulted in being a larger negative burden on the investment than when assessed during the decision making process. Other factors that the respondent believes should have been considered during the investment appraisal process include labour cost and availability, business organisations and population characteristics.

Influence of Taxation Issues

The respondent did not list any taxation factors that were considered highly critical to the investment decision (rating them one out of a possible five). Among the tax factors flagged as relevant were the basic corporate tax rate, income taxes, perceived stability of tax system and administration, and perceived level of corruption existing within the administration.

Income taxes were however cited as being highly important to the investment decision (scoring two out of a possible five) because the rates of income taxes in Macedonia are relatively high. Tax holidays were explicitly referred to within the

survey, but were not considered large enough to have an important influence in the results of the operating activities.

The level of stability of the taxation system in Macedonia relative to other South East European countries was explicitly referred to as an important factor in choosing Macedonia as the location of its investment.

The overall response of this company reflects the majority of the responses that were received from the investor survey. This is based on the insight that for the investor, macro level risk factors such as political and economic stability are considered far more critical in the investment decision than taxation. Where tax factors were referred to, the stability of the taxation system was deemed to be more critical than the burden of taxation itself. This again reinforces the conclusion that strategic investors seek long-term stability rather than short-term gains from tax regimes. Gains through tax incentives are often nullified by the perceived instability of the taxation system. As the investor stated when referring to their choice of Macedonia, the stability of the taxation system was an important investment consideration.

4.3 Case Study Three

Company profile:	Healthcare provider Company
Country of Investment:	Bosnia-Herzegovina
Size of Investment:	0-5 \$ USD million
Type of Investment:	Strategic

Background

The company is a leading healthcare provider that is focused on Central and Eastern Europe. The company has also invested in the CIS.

The company invested in Bosnia based on a general strategic decision, where the objective was to obtain long-term competitive advantage. As the focus of the company is on Central and Eastern Europe, countries outside of this region were not considered.

Investment decision Process

No features of the operating environment were considered critical to the investment decision. Factors highlighted as important were business legislation and the profitability of the venture. Other important factors included political stability, economic environment, economic reward, administrative burden, and the rule of law.

Major obstacles to the investment in the South East European region were bureaucracy and the general reluctance to make business decisions by key officials. The major positives of the investment location were tax benefits and the lack of competition.

Influence of Taxation Issues

The respondent identified a number of taxation factors that were critical to the investment decision in Bosnia. These were the corporate tax rate and withholding tax rates. Not considered important (scoring the lowest out of a possible five in terms of importance) were enhanced capital expenditure write-offs and the home country's tax agreements.

The company did not negotiate tax incentives with the host government. The respondent highlighted the tax benefits from the investment offered by government as the most important perceived benefit and that it outweighed the negative country level factors that were seen as obstacles to the investment.

The respondent company appeared to make its investments based on an overall strategic view and made its entry when the investment conditions gave the greatest benefit. This is another example of a strategic investor looking to make a choice between countries and highlighting the importance of taxation. In this case, the rate of corporate and withholding taxes was critical to their choice of country. Unlike other strategic investors, factors in the operating environment were not considered critically important by this investor.

4.4. Case Study Four

Company profile:	International Manufacturing Company
Country of Investment:	Romania
Size of Investment:	2-100 \$USD million – depending on initial success
Type of Investment:	Strategic/Opportunistic

Background

The company is a global manufacturer with operations in Europe, the Middle East, North and South America and Asia Pacific. The company is currently still undertaking the appraisal process in Romania. The company is also currently considering investment opportunities in Hungary, the Czech Republic as well as Romania.

Investment decision Process

The investment in the South East European region by the company was made as a response to a specific business opportunity. Wider investment factors were also identified by the respondent when considering the investment. Based on the overall response of the survey, we consider this company to fit more closely within the strategic profile of our international investor.

Sector specific factors (such as competitor activity) and the profitability of the venture were considered highly critical to the investment decision. Still considered important were the economic environment, economic reward, regional integration, business legislation, administrative burden, and rule of law, business infrastructure, land specifics and business organisations.

The most important obstacle to investment in the South East European region was considered to be bureaucracy, followed by hidden agendas (on the side of the government decision-makers), poor data sources and corruption. Major positive factors were held to be the business opportunity, medium to long-term development and growth potential. Attractive according to the respondent were the competitive situation, the geographic location and the “emerging stability” of the country and region.

The respondent made the observation that reflects the general approach of investors who **eme** spoke to during the survey: “Balancing the risks against the opportunity is a key judgement call. Both are hard to assess even with full due diligence.”

Influence of Taxation Issues

The respondent cited taxation factors overall as being fairly important to the investment decision. There were no specific factors that were highlighted as being more important than others. The respondent did note that the company is currently negotiating tax incentives in the host country. Because the nature of the sector involved high initial capital costs and a long payback period, up front savings from tax incentives can make a significant impact on the discounted cash flow and were specifically referred to. The respondent commented that the nature of their business did not allow them to incrementally increase the amount of investment based on the increasing success of the project.

The respondent confirmed in detail how taxation factors were incorporated into cash flow analysis. Current taxation regimes were incorporated and analysed at 10% downward changes in tax regimes to assess the proposed investment. The comment was made that although in their experience, tax changes generally are more favourable for their investment, Romania had recently undergone a change in its taxation system that decreased its attractiveness to the company.

For this company, the large capital costs and long-term nature of the investment ensured that cost savings at the early stages of the project that could be quantified were important. The company had one of the most sophisticated investment appraisal processes from the respondent companies, reflecting the highly capital intensive investments that are required in the respondents industry. As a manufacturer for a regional market, reduction in start up costs in the capital intensive stages of the investment were important, rather than the market characteristics of the target country. Thus, taxation factors were important to this investment decision (following a short-listing of countries), and the company undertook calculations of profitability of the proposed investment with changes to the present taxation structure. The respondent did make the comment that the developing stability of countries in South East Europe was in a positive direction, and that taxation

structures usually followed this positive path. However, using Romania as an example, the respondent noted that taxation systems can change to the detriment of their investments.

4.5 Case Study Five

Company profile: International Manufacturing Company

Country of Investment: Bulgaria

Size of Investment: 1-3 \$ USD million

Type of Investment: Opportunistic

Background

The respondent is involved in the tobacco industry, and has also made investments in Macedonia in South East Europe. The investment was a 100% foreign owned by the respondent's company.

Investment decision Process

The investment in Bulgaria was made as the result of a specific business opportunity. It was not the result of the privatisation process in the country. The primary drivers of the business decision were cheap assets and access to raw materials.

Wider factors such as political stability were also considered after the initial opportunity was identified. Factors considered critical to the decision process were macroeconomic environment, sector specific factors and profitability calculations. Other factors considered important included political stability, local tax system, business legislation, local tax administration, administration burden and rule of law.

Factors not considered or not important included capital cost and availability, social and business infrastructure. The respondent identified major negative factors as economic and political stability and the role of government in descending level of importance. Sourcing of raw materials was considered the most important factor in the investment decisions.

Influence of Taxation Issues

The respondent cited problems created by the high level of uncertainty surrounding tax compliance and tax rates as featuring heavily in the investment decision. This was considered a key risk factor when the company was assessing the local business environment.

Instability and uncertainty relating to all tax and regulatory issues was considered highly critical to the investment appraisal process and final investment decision. The respondent cited burden of compliance with tax rules, indirect taxes, income taxes, perceived stability of the tax system and perceived levels of corruption existing within the taxation administration as being critical to the investment decision.

The company did not attempt to negotiate any tax incentives with the government of the target country. Taxation factors not considered important to the investment decision included corporate tax rate, targeted tax incentives and enhanced capital expenditure.

Conclusions to Case Studies

These five case studies illustrate the results presented in Section Three. In general, strategic investors focus their location decision on the level of opportunity as reflected by market potential and the risks inherent in operating particular countries. Taxation is later taken account of, and in some instances, may be critical to the choice of location. But, in general, it is a minor factor in the decision-making criteria.

For opportunistic investors who are focused on the predictability of the tax regime rather than the level of taxation, uncertainty over the net returns to the project decrease country attractiveness. For the opportunistic investor, the critical factor is the net return of the project.

V. THE INVESTMENT DECISION PROCESS AND KEY DETERMINANTS

Investments by corporations are essentially a balance between the projected return of the project (i.e. profits) and the perceived risk associated with that investment. In countries where the risks of operating and investing are higher, the required return from that investment must accordingly reflect this higher level of risk (i.e. a premium is added). Where there is an absence of effective governance to create stable and predictable rules for conducting business, (such as an effective legal system), the required returns must be proportionately higher to justify the investment.

eme has worked with a number of companies to develop their investment strategy in a wide range of developed and emerging markets. Through this we have developed some practical insights into how companies perceive taxation issues and how taxation factors are integrated into the investment process – particularly when assessing what countries should be included in a shortlist of attractive countries that warrant further analysis.

We have therefore set out below two examples of companies for whom we have undertaken country level screening in Eastern Europe.

5.1. Case Study Example 1 – UK Facilities Management Company

eme worked with an international facilities management company in 2001 to define a strategy for expanding their services in Central and Eastern Europe. The company had operations in a number of countries in Western Europe, with the majority of its operations within the UK. All countries in South East Europe included in the investor survey for the purposes of this report were included in **eme**'s country screening analysis for this client.

Working with the client, **eme** developed and quantified a number of key indicators that reflected the risk and opportunities of the countries in question. A primary source of the data was the EBRD Transition Report of 2000. The objective of the analysis was to develop country scores for two key indicators that were subsequently plotted against each other: a company specific attractiveness score for an individual country, and an overall individual country attractiveness score.

The factors considered for each of the elements were the following:

Company Specific Attractiveness	Country Attractiveness
<ul style="list-style-type: none"> - Nominal GDP (\$ billion at PPP) - Government spending (% of GDP) - Public Debt (% of GDP) - Exchange Rate stability - Progress in transition indicator - Changes in Public Sector 	<ul style="list-style-type: none"> - Country risk ranked by composite risk rating - GDP per head (\$ at PPP) - Risk Stability - Corruption Perception Index - Legal Framework - FDI inflows - Restriction on Foreign Investment

As can be seen from the variables above, taxation factors were not listed as separate and defined variables in the analysis. The Progress in Transition variable was an aggregated calculation from enterprise, markets and trade and financial institution indicators. Within these indicators, taxation levels and incentives are not explicitly referenced as a determining factor upon indicator scoring. The restrictions on foreign investment variable were based on Index of Economic Freedom indicators and address the treatment of foreign investors compared to domestic operators, with particular emphasis on laws and procedures to determine an overall score of the countries' investment environment.

For this investor, what mattered was the level of opportunity offered by a country and the associated risk of doing business there. Taxation did not play an important role in the screening exercise.

5.2. Case Study example – UK High Street Fashion retailer

eme recently worked with a UK based high street fashion retailer that wished to develop a European focused expansion strategy. The output of **eme's** work was a shortlist of countries based on our country screening work that offered the best balance between risk and reward, as defined by criteria developed by working alongside board level management.

All South East European countries were initially considered to be potential markets that were included in the screening process. An initial group of countries was then eliminated through a composite score of GDP and population, benchmarked against

the United Kingdom, which excluded some South East European countries that are the subject of this report.

Developing a Screening Model

Working with the client, **eme** developed a number of key elements for which indicators could be gathered, measured and compared. The United Kingdom was used as a benchmark for comparing countries against each other. Significant time was also spent with the client developing composite weightings for each element, that reflected the clients risk and reward preferences.

There were five key elements developed for the screening process, each assigned a weighting that combined to generate an overall country attractiveness score:

I. Market Attractiveness: Is the market attractive for the client?

This included population measures, GDP per head data and extent of urbanisation and sector specific variables. The weighting for this variable was 30%.

II. Market Growth: How fast is the market growing?

This focused primarily on GDP growth measures and included growth in sector specific expenditure and population statistics. The weighting for this variable was 30%.

III. Market Competitiveness: How full is the market?

This element primarily focused on how developed the particular sector was in each country though measures such as number of stores and dominance of top market players. The weighting for this variable was 20%.

IV. Country Risk: How risky is the country?

Legal issues, level of corruption, political, economic and social issues were included within this element. Political and economic issues were given the largest weighting, with the legal system next followed by corruption and social measures. Legal issues included transparency and fairness of legal system and regulatory framework. Economic issues included macroeconomic measures, levels of public debt and

inflation while political indicators included political stability, government effectiveness and intervention in the economy. The weighting for this variable was 10%.

V. Business Risk: *How easy is it to do business there?*

This included measures of labour, property, infrastructure and taxation issues. Labour indicators included measures of labour availability and quality and wage costs indexes were given importance within the business risk element. Property issues covered rental costs while infrastructure included banking system openness and overall bureaucracy ratings. Taxation made up 30% of this overall score. The taxation variables are described in more detail below. The weighting for this variable was 10%.

What was measured within the taxation analysis?

Within taxation factors, there were three key indicators that made up the overall taxation score. These were the overall tax regime rating, the corporate tax burden and the fairness of the taxation system. Overall tax regime rating included value-added tax, employers social security contributions, top marginal personal income tax, corporate tax rate, degree to which fiscal regime encourages new investment, and fairness of the taxation system. Corporate tax burden and the fairness of taxation system were selected separately to reflect their higher importance to the client. No other taxation issues such as the availability of taxation incentives or tax holidays were included.

During the presentation of the results to the client, more importance was given to the results of the country risk element than the business climate results – which included taxation factors. This was because there were far greater differences in the scores achieved by countries in terms of country risk than in the measure of business climate – country risk measures captured differences between countries in terms of levels of corruption, a functioning legal system and economic stability. Business climate scores – where measures of taxation were included – did not demonstrate as large a range of scores.

The key driver for the client for this exercise was to identify what countries held the greatest potential for growth and were relatively underdeveloped. Thus taxation

issues were not considered critical at this stage of the assessment process. Because of the highly competitive nature of the industry within which the client operated, the potential of the market was the key consideration in the screening process. Taxation issues were raised in dialogue between **eme** and the client, and were considered within the screening process, but were a minor factor within the screening analysis when compared to other key drivers.

Implications of these Screening Models

The analysis that was undertaken for these clients highlight the fact that for many companies that are developing a strategic approach to international investment, the overall attractiveness and characteristics of the market were the key business drivers. When investigating where a company should invest on a strategic level, which involves an analysis of where to devote attention and company resources, taxation factors are normally not an important influence on country level analysis.

This must be however qualified by the fact that the risk preference and key business drivers for these clients are unique, and companies with a more developed international presence could have a different risk and reward profile. Other motivations (i.e. such as cost saving) or different investment time scales might consider and integrate these (and additional) variables within calculations of country attractiveness that take higher – or lower – account of taxation issues. For companies that operate on a low margin, are global, and have a high degree of mobility, such as some IT manufacturing industries, taxation factors that have an immediate and quantifiable effect on profitability are likely to play a greater role in location and investment choice.

The two screening models detailed above, however, reflect the overall results of our investor survey in Section Three, and some of the insights provided by individual case studies in Section Four of the report. The general conclusion reached is that for those companies approaching investment strategically, taxation issues are sometimes identified and considered within the country screening process, but normally are not a critical issue when compared to other business drivers. And typically where they are identified, the relevant concerns are transparency and complexity, rather than the tax burden.

VI. CONCLUSION

There is considerable consensus in the literature on the determinants on FDI. Investors are believed to respond to two types of factors:

- **Market opportunity** – defined as attractiveness of the market (size, growth) and/or cost advantages;
- **The degree of risk in the operating environment** – which includes economic, political, governance and socio-cultural factors.

This accords with the view that investors seek to maximise the risk adjusted return after tax from investments. Investment in emerging markets is motivated by the assumption that rates of return in these countries are likely to be high but subject to greater levels of risk than operating in developed countries. Investment locations need to offer attractive opportunities in a comparatively secure, low risk environment for investors if they are to attract substantial and sustained FDI flows.

In the central and SEE countries, privatisation has served as the vehicle for attracting FDI by offering rewarding opportunities for investors. Countries that have managed to attract investment independent of privatisation (such as Poland) are those that have been able to offer a secure operating environment for FDI. Political stability and positive attitudes on the part of government towards FDI are essential features of such an environment.

In the literature, taxation and its reciprocal tax incentives, are regarded as not important to the investment decision. Our findings suggest that, though other factors may be more important, taxation may be an important criterion for investment. It impacts investment in one or more of four possible ways:

- it impacts the net (after tax) rate of return to the investment;
- indirect taxation impacts prices and levels of demand and hence the market opportunity;
- taxation regimes are a source of project risk;
- compliance can add to transaction costs.

In order to gain insights on how taxation affects investor behaviour, it is important, firstly, to understand the nature and context of the investment. A simple categorisation of investors into strategic and opportunistic offers valuable insights.

For the strategic investor, the motive for the investment lies in strategic considerations of business strategy. The critical investment decision is *where* to invest not whether to invest. For such investors, the initial screening of countries may well include taxation as a factor. In the survey carried out by **eme**, 44% of strategic investors actually considered taxation to be a critical factor in the investment decision. These investors were concerned with the basic or general rate of tax, the computation process for individual investments, transparency and the tax burden.

For the majority, tax factors are important, but not as important as other factors in the operating environment such as political and economic instability. This is borne out by **eme's** experience in screening countries for our clients to invest in. The case studies of our two clients illustrate this point as do the case studies of respondents to our survey. In addition to considering the general rate of taxation during the initial screening of countries, at a later stage of the investment decision making process, strategic investors revisit taxation, particularly the incidence of taxes specific to their industry (royalties, indirect taxes). When there are such specific taxes, taxation may become a critically important factor.

In general, the opportunistic investor considers taxation to be an important but not critical factor to the investment decision. Such investors are concerned with *whether* to invest not *where* to invest. The location of the investment is a given. Our survey found that these investors were concerned with market position, the cost of assets and cost advantages. The focus for the opportunistic investor is the returns from a specific investment. Provided the gross returns are high enough, the rate of taxation is not critically important. Such investors were concerned more with the transparency of the system and the burden of compliance than with the rate of taxation. The case study revealed a concern also with the stability of the taxation system.

The case studies of respondents and our clients show that the techniques used for arriving at location choice are quite sophisticated. Faced with a range of countries to choose from, investors subject the location to a range of criteria and may attach weights to differing criteria. For policy makers, the implications are clear. They must address a range of factors that make up the investment environment systematically, rather than focus on factors such as taxation individually. The empirical evidence and our survey shows some investor responsiveness to rates of tax, but results are sustained only if the overall investment climate improves.

Moreover, changes must occur at all levels of the tax regime, transparency, individual tax computation and the burden of compliance, not just tax rates or incentives. Many investors attach importance to these wider tax issues. If there is an element of taxation to which few investors attach importance, it is indirect taxation, but even rates of indirect taxation cannot be set without reference to their effect on investment.