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TAX COMPETITION REGARDING FOREIGN DIRECT INVESTMENT BETWEEN TRANSITION EUROPEAN COUNTRIES

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This paper explores the fiscal measures adopted in the transition European countries in order to encourage the foreign direct investment. There were analysed six countries: Albania, Macedonia, Moldova, Russian Federation, Union of Serbia and Muntenegro, Ukraine, based on the four criteria: corporate and capital gains tax rates, withholding taxes, tax incentives, foreign tax relief and transfer pricing rules. Finally, the conclusion is that all the analysed countries offer favourable fiscal conditions for the foreign direct investment. Serbia, Muntenegro, Macedonia and Moldova have attractive fiscal regimes, showing that the authorities from these countries count on the foreign direct investment as a solution of solving the social and economic problems.

Keywords: *foreign direct investment, business environment, tax competion, transition European countries*

1. Introduction

Started from the end of the XX-th century, the process of transition to the market economy of the ex socialist countries had various evolutions. In some states the transition took place in a fast rythm, so that nowadays it may be considered finished, at the same time with getting the status of functional market economy. In this group there are included the countries already integrated into the European Union (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia), two countries (Romania and Bulgaria) very close of the integration and another country, Croatia, with a functional market economy, but whose integration was delayed by some aspects of the domestic policy. Another group is composed by ex socialist countries (from the Balkans, from the Independent States Community and from Indochina), whose transition to the market economy started slowly and it is still far from the finish, from various reasons: significant cultural differencies in comparison with the Western European countries, wars in the Balkans, dependence of Russia a.s.o. The main obstacles of the foreign direct investment from the transition countries are the risks and some administrative difficulties. These obstacles are yet compensated by the very reduced price of the labour force so that, generally, the foreign direct investment from the transition countries proved to be very rewarding. It came out that, at the same time with getting the status of functional market economy and coming closer by the European Union, the foreign direct investment became less promising because of the labour force price increase and because of reaching saturation levels in some fields of the economic activity. As a consequence, in the last years some multinational companies redirected the foreign direct investment towars the current transition countries [2]. In the same time, the attitude of the authorities from these countries regarding the foreign direct investment changed from an obvious reticence to the policies elaboration in order to attract the foreign capital.

Nowadays, the transition countries are in a competition regarding the foreign direct investment encouragement, using different tools [1]. The fiscal instruments are very efficient, having a considerable impact on the investment intentions and the authorities control them thoroughly.

In this paper there will be compared, for the beginning of the year 2005, the fiscal conditions offered for the foreign direct investment by the authorities from six transition European countries: Albania, Macedonia, Moldova, Russian Federation, Union of Serbia and Muntenegro (the major differencies between the fiscal systems of the two components of the union imposed their separate treatment in this analyse), Ukraine. These countries were chosen because they are nowadays in competition, having somehow similar positions regarding the political stability and the authorities' attitude about the foreign capital in order to encourage the foreign direct investment. There were not included in the group the Caucasian countries because that region is for the time being perceived as quite unstable from the political point of view and neither Belarus was included because the authorities from this country have an ambiguous attitude towards the foreign capital. Moreover, the comparison was not extended to the countries from the Central Asia or from Indochina because of the major cultural differencies from the European countries. As comparison criteria there were used some fiscal aspects of the business environment, with a significant role in the investment decisions of the multinational companies:

- corporate and capital gains tax rates;
- withholding taxes;
- tax incentives;
- foreign tax relief and transfer pricing rules.

The data used in this analyse were taken from the work "Worldwide Corporate Tax Guide", elaborated by Ernst & Young – a company of financial consulting, where there are presented the taxation conditions of the corporations from 150 countries, valid at January 1st 2005.

2. Corporate Income and Capital Gains Tax Rate

For a lot of multinational companies corporate income and capital gains tax rate represent the most important fiscal criterium used in order to choose the countries where they will invest.

Table 1 - Corporate Income and Capital Gains Tax Rates in Transition European Countries

No. crt.	Country	Corporate Income Tax Rate	Capital Gains Tax Rate
1.	Albania	25 %	25 %
2.	Macedonia	15 %	15 %
3.	Moldova	18 %	9 %
4.	Russian Federation	20 % / 24 % from which: - 5 % payable to the central government; - rate ranging from 13 % to 17 % payable to the regional governments; - 2 % payable to the local level.	20 % / 24 % from which: - 5 % payable to the central government; - rate ranging from 13 % to 17 % payable to the regional governments; - 2 % payable to the local level.
5.	Serbia	10 %	10 %
6.	Montenegro	- 20 % applies to taxable income exceeding 100 000 euro; - 15 % applies to taxable income up 100 000 euro.	- 20 % applies to taxable income exceeding 100 000 euro; - 15 % applies to taxable income up 100 000 euro; - a 15 % withholding tax is imposed on capital gains derived by nonresident companies individuals.
7.	Ukraine	25 %	25 %

Source: Ernst&Young (2005), The Worldwide Corporate Tax Guide, EYGM.

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In the analysed countries corporate income tax rates vary between 10 and 25 %. Among these Serbia has a special situation, whose corporate income tax rate (10 %) is close to those from tax heavens. Other quite reduced values are practiced in Macedonia (15 %) and Moldova (18 %), while higher values are in Montenegro (15 and 20 %), Russian Federation (between 20 and 24 %), Albania (25 %) and Ukraine (25 %). If there are compared these values with the ones from the seven most developed countries (22 % in Canada, 25 % in Germany, 30 and 15 % in United Kingdom, 30 % in Japan, 33 % in Italy and France, 35 % in United States, it comes out that the transition countries offer, in this matter, quite attractive conditions for the foreign direct investment.

Generally, for the analysed countries, capital gains tax rate is equal to corporate income tax rate. Moldova is an exception, having a capital gains tax rate of 9 %, less than corporate income tax rate of 18 %, this fact could be a considerable advantage for the foreign direct investment.

3. Withholding Taxes

Withholding taxes are important for the multinational companies because they influence incomes received from the foreign direct investment, especially those as dividends, interests and royalties.

From the analysed countries, Macedonia has a special situation because there are not applied withholding taxes on interests and royalties (these are included in taxable income and there are subject to tax at the regular corporate income tax rate of 15 %) and dividends received by companies are not imposed if the payer has paid its corporate income tax.

Table 2 - Withholding Tax Rates in Transition European Countries

No. crt.	Country	Dividends Withholding Tax [%]	Interest Withholding Tax [%]	Royalties Withholding Tax [%]
1.	Albania	10	10	10
2.	Macedonia	0	0	0
3.	Moldova	10 / 18	0 / 18	15 / 18
4.	Russian Federation	15	15 / 20	20
5.	Serbia	20	20	20
6.	Montenegro	15	15	15
7.	Ukraine	15	15	15

Source: Ernst&Young (2005), The Worldwide Corporate Tax Guide, EYGM.

Generally, the other countries apply the same withholding tax rate for dividends, interests and royalties. There are exceptions Moldova and Russian Federation, that apply different rates for the three categories of incomes. Withholding tax rates vary from 10 % in the case of Albania to 20 % in the case of Serbia and for the royalties and some interests obtained in the Russian Federation. These values are included in the withholding tax rates practiced in the countries with a functional market economy.

4. Tax Incentives

In certain conditions, tax incentives surpass the other fiscal criteria of the decisions regarding the foreign direct investment [3]. These could be a considerable competitive advantage for the transition countries, taking into account the fact that in the countries with functional market economy, especially in those from the European Union, tax incentives are not used very often. However, three from the analysed countries: Albania, Russian Federation and Ukraine don't offer significant tax incentives. The other countries from the analysed ones apply different types of tax incentives. Macedonia offers a reduction of taxable income, equal to the amount of expenditures on fixed assets, without conditioning this tax incentive by the investment size or by the labour force employment. Moldova offers a 50 % reduction of the standard corporation income tax for a five year period towards those foreign companies that invest more than USD 250,000. Serbia and Montenegro offer different tax incentives depending on the invested sums, on the impact upon the labour force and on the regions where there is invested. It comes out that the most attractive tax incentives are offered by Serbia, where there could be reached a ten year tax exemption.

Table 3 – Main Tax Incentives for Transition European Countries

No. crt.	**Country**	**Main Tax Incentives**
1.	Albania	- no significant tax incentive
2.	Macedonia	- reduction of taxable income equal to the amount of expenditures on fixed assets
3.	Moldova	- Companies with foreign participation can obtain a 50 % reduction of the standard corporation income for a five year period if the foreign investment in company's share capital exceeds USD 250,000
4.	Russian Federation	- no significant tax incentive
5.	Serbia	- ten year tax exemption for companies which invest more than 9 millions euro and employ more than 100 new workers; - five year tax exemption for companies which perform activities in a region of extraordinary importance; - decrease of calculated tax by an amount equal to 20 % of investment in fixed assets, but the tax credit may not exceed 50 % of the calculated tax for the year of the investment; - tax credit for companies which establish new business units in an undeveloped region
6.	Montenegro	- a 100 % tax credit for three years is granted to a newly established company in an undeveloped municipality; - reduction of corporate income tax equal to 25 % of the investment made in fixed assets in the tax year, subject to a maximum limitation of 30 % of the tax for the year
7.	Ukraine	- no significant tax incentive

Source: Ernst&Young (2005), The Worldwide Corporate Tax Guide, EYGM.

5. Foreign Tax Relief and Transfer Pricing

For the multinational companies, foreign tax relief and transfer pricing represent important ways of taxes reduction, so these aspects could be an important criterium for the decisions regarding the foreign direct investment. The foreign tax relief is conditioned by the existence of a tax treaty between the resident country for the company that invests and the country where it invests. Moreover, for the multinational companies it is very important the procedure for establishing the income tax due in the resident country, supposing that the income taxes paid abroad are taken into consideration: by tax credit or by exempting foreign source income from tax.

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Table 4 – Foreign Tax Relief and Transfer Pricing in Transition European Countries

No. crt.	Country	Foreign Tax Relief	Rules over Transfer Pricing
1.	Albania	- tax treaties signed with the main developed countries, including both exempting foreign source income from tax and tax credit	- no special rules against transfer pricing
2.	Macedonia	- tax treaties signed with the main developed countries including, in general, tax credit	- no special rules against transfer pricing
3.	Moldova	- tax treaties signed with the main developed countries including, in general, tax credit	- no special rules against transfer pricing
4.	Russian Federation	- tax treaties signed with the main developed countries including, in general, tax credit	- no special rules against transfer pricing
5.	Serbia	- tax treaties signed with the main developed countries including, in general, tax credit	- transaction between related parties must be made on an arm's length basis
6.	Montenegro	- tax treaties signed with the main developed countries including, in general, tax credit	- transaction between related parties must be made on an arm's length basis
7.	Ukraine	- tax treaties signed with the main developed countries including, in general, tax credit	- no special rules against transfer pricing

Source: Ernst&Young (2005), The Worldwide Corporate Tax Guide, EYGM.

Usually, the multinational companies prefer the procedure exempting foreign source income from tax, that facilitate transfer pricing, in transaction between related parties with the purpose of reducing the taxable incomes [4]. However, from the same reason the countries prefer, in general, the procedure tax credit. Usually, the analysed countries apply only the procedure tax credit, exception being Albania that apply exempting foreign source income from tax, in relations with certain countries.

Tax credit makes very difficult transfer pricing, but it can not eliminate it competely. In the developed countries, from this reason special rules against transfer pricing are in force. However, excepting Serbia and Montenegro, the analysed countries do not apply such rules and this fact is considered an advantage from the perspective of the multinational companies.

6. Conclusions

In this paper it was analysed the fiscal dimension of the conditions offered for the foreign direct investment in some transition European countries. There were approached more fiscal aspects that the multinational companies are interested in: corporate and capital gains tax rates; withholding taxes; tax incentives; foreign tax relief and transfer pricing. It resulted that all the analysed countries offer quite favourable fiscal conditions for the foreign direct investment, materialized in corporate income tax rates lower than the ones usually practiced in the developed countries, in some attractive tax incentives and in the possibilities of foreign tax relief and of transfer pricing. However, there were observed different degrees of applying the fiscal measures to encourage the foreign capital.

Unquestionably, the most attractive fiscal conditions for the foreign direct investment are offered in Serbia, with a corporate income tax rate of 10 % and substantial tax incentives, that compensate the quite high withholding tax rate and the special rules against transfer pricing. This situation reflects the authorities preoccupation in Serbia to encourage the foreign capital, as a solution for the bad condition of the economy. Very favourable fiscal regimes for the foreign direct investment are offered by Macedonia, Moldova and Montenegro, countries that also confront with a difficult situation of the economy. The other analysed countries: Albania, Russian Federation and Ukraine offer less favourable fiscal conditions for the foreign direct investment, although they are attractive in comparison with those from the developed countries. The reasons are different from one country to another.

In Albania, although it has a little developed economy, the necessity of the foreign direct investment is not very pressing for the authorities, while a considerable part of the population works abroad. In Russia the domestic capital is strong and in certain fields of activity there are groups of interests that act in order to deny the foreign capital acces. Finally, in Ukraine the quite short period from the „Orange Revolution" didn't permit the elaboration of a coherent policy in the field of the foreign direct investment.

It is expected that in the same time with getting the status of a functional market economy the transition european countries become a favourabletarget for the foreign direct investment.

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