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Tax competition for FDI in Western Balkans

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Tax Competition for FDI in Western Balkans

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Table of Contents

List of Acronyms

CIT – Corporate Income Tax

DC – Developing Countries

DT – Double Taxation

FDI – Foreign Direct Investment

FI – Fiscal Incentives

GDP – Gross Domestic Product

TI – Tax Incentives

WB – Western Balkans

Executive Summary

The aim of this project is to study the application and effectiveness of tax incentives (TI) in the countries of Western Balkans (WB), more specifically in Albania, Kosovo, Macedonia, and Serbia. Based on the research made of the field of TI it was found that all these countries have applied certain forms of TI. The reasoning behind the decisions of the government officials to apply FI in these countries was the belief that the application of these incentives would increase the level of FDI inflow. By being able to increase the level of FDI inflow, countries would experience a faster economic growth which would further decrease the level of unemployment.

Testing the existence of these relationships remains the main theme of this project. The analysis done for testing this relationship is made in two separate phases. Firstly, a separate analysis for each country was made to control for the relationship between levels of FDI with the GDP growth, then another similar analysis was made to control the relationship of FDI level with the Unemployment rate. Finally, a cross country analysis was made in order to test for the effectiveness of tax policies applied by countries. The cross-country analysis was done by calculating for the total percentage of GDP which is filled by FDI inflows.

Introduction

Most governments in the world nowadays give a huge importance to the economic well-being of the country. They invest huge amounts of time and money to conduct proper research and analysis on new strategies and economic models which will help them improve the economic indicators of their country. One of the most important indicators that portray the aspiration of a country to improve its economic performance is economic growth. Economic Growth stands for the increase in a country's capacity of production, trade etc. which is directly reflected in a higher Gross Domestic Product (GDP). In order to have a better understanding of GDP, I will make a short explanation about the elements that compound it. As taught in the very basic courses of economics, GDP represents the total sum of consumption, investments, government expenditures, and net exports of a country. In order to have a positive GDP growth, the country should have a mixture of positive changes in all factors of the GDP.

$$\mathbf{Y = C + I + G + (X - M)}$$

In the formula we can see that one of the main factors that will cause a GDP to increase is investment. Investments as part of GDP, count for the total sum of domestic and foreign investments in a country (FDI). The domestic investments made from the citizens within a country are essential elements of investments level in one country, nevertheless themselves only are not sufficient to generate great economic growth. In order to achieve a more rapid GDP growth, countries should be able to attract additional FDI. FDI are investments made by foreign investors by entering their capital in your country and using it to generate production of goods and/or services. The scale of being successful enough to attract more FDI is based on the ability and the willingness of the government officials of the host country to provide financial and in-kind incentives, which will create a more investment friendly business environment.

In today's globalized economy, commonly worldwide used instruments to attract FDI are FI, specifically TI. As defined in the business dictionary, TI are: "a deduction, exclusion, or exemption from a tax liability, offered as an enticement to engage in a specified activity (such as investment in capital goods) for a certain period. [1]" They remain an important fiscal instrument used by both, developed and DC. Additionally, government officials, economists, and policy makers have shown an increasing tendency to use them for achieving different political and/or economic goals. Getting to know the real benefits behind using TI remains an open ended question yet. Economists argue that the benefits of using TI depend on several economic and political factors which are country specific. Thus, there is no possibility of offering a generalized answer or economic model that can be applied worldwide. For a more accurate result and explanation, separate country of region specific economic analysis should be made. Following this issue, I have conducted an analysis on the tax incentive policies adopted in the region of WB, specifically in Albania, Kosovo, Macedonia, and Serbia. The main focus of this project is to analyze the effects of tax incentive policies in the level of FDI in the DC, by concluding whether their adoption is appropriate and successful in these economies or not.

[1] Business Dictionary, *"Tax Incentive",* par.1

Statement of the Problem

Results of empirical analysis made on the effectiveness of TI in attracting FDI show diversified results. Almost a same situation can be also seen in the academic sphere. Economists specialized in the tax field have different beliefs and share different arguments. Some propose TI as a good strategy to attract FDI, while others strongly oppose it.

Proponents argue that TI remain a good strategy which has worked properly by causing an increase in the level of FDI in a country. In the other hand, proponents argue that an application of TI is in contradiction with a law against the harmful tax competition on which was amended on December 1, 1997 by the European Union. This amendment was made in order to protect and promote a fair competition, which by EU is considered to have positive effects on the International Economy. The code amended by the EU has a political power, and countries who obey this rule should: "roll back existing tax measures that constitute harmful tax competition and refrain from introducing any such measures in the future ("standstill")[2]."

Driven forward by this disagreement that exists between the economists regarding the importance of TI in promoting FDI, this project seeks to provide further analysis on the effectiveness of TI in countries of WB like Albania, Kosovo**,** Macedonia, and Serbia which mostly had a former centrally planned economy. When a country decides to introduce TI it should be careful in taking into consideration past experiences of this practice. As mentioned above, up to now there is no clear definition whether the TI remains a successful fiscal instrument available to governments or not. The effects of FDI to promote economic growth in transition economies, like Kosovo, gave mixed result as well. A broader analysis of the FDI effects on transition and developing economies has showed that:

> *"FDI in the transition economies since 1990 has largely flowed to just a few central European countries, which are also the leading candidates for EU membership. These have indeed benefited from significant FDI financing of the balance of payments, and enterprises with foreign investment, not surprisingly, have had high rates of growth of output, productivity and exports. However, the expected spillover benefits to purely domestic enterprises which represent the broader advantages of FDI for economic development are found to be few and far between, and indeed often appear to have been negative rather than positive.[3]"*

[2] European Commission, *"Harmful Tax Competition"*, p.2.

[3] UNECE Information Service – UNECE, *"Economic growth and foreign direct investment in the transition economies."* P.1.

Background information

All WB countries like Kosovo, Albania, Macedonia, and Serbia which are part of this analysis, have already applied TI as a fiscal instrument to attract more FDI. The common sense behind the decision of these to apply TI was the belief that TI are positively related to the level of FDI. More TI will make the investment more attractive to foreign investors so, the total level of FDI would eventually increase. Such an increase in the level of FDI will be manifested in a more rapid economic growth and creation of additional jobs. Furthermore, public policies applied by WB countries including the fiscal ones has always been subject to changes in response to shocks in political stability (war, social upraises, dissolution of former Yugoslav Republic, and negotiations) and economic stability (domestic and foreign economic and financial crisis).

The application of a proper fiscal strategy by some countries mentioned above, have proven to be an appropriate form to increase the level of FDI. Despite this fact, other countries have preferred to use other non-ficsal incentives like free legal procedures and improved security instead. For instance of having a clearer picture of the reforms applied, the following section will correspond to a short summary of TI applied in WB.

Albania, which is the first country to be analyzes in this project, has adopted several incentives that include corporate tax reduction (from 20% to 10% in January 2008), increase in the level of security, CIT reliefs etc.[4] Secondly, Kosovo has amended the Law on CIT (law No. 03/L-113) by modifying the article 15, 21, and 26. These articles regulate the tax rates and tax practices applied to businesses. Macedonia in the other hand, as part of incentives to attract FDI has made three basic steps: Firstly, it has joined "the club of flat tax reformers in Eastern Europe." These reforms have given good signals of an increase in tax revenues, and stimulation of new jobs.[5] Finally, Serbia has applied a strategy that allows the investors "for free transfer of their profits and repatriation of invested capital, exemption from the profit tax for 10 years for investors who invest and amount exceeding 600 million CSD (app. EUR 7 million) and also employs at least 100 employees, tax holidays up to five-year tax holiday for companies investing CSD (Serbian

[4] Kurti, Leona, and Christoss Masos. "Albania." *World Tax*. p.1.

[5] IMF Survey, "*IMF Survey: Macedonia Makes Early Headway After Flat Tax Debut*" p.1

Dinars) 6 million and employing a minimum of five workers in underdeveloped regions, in proportion to investment." etc.[6]

The table below summarizes the fiscal and in-kind incentives applied by each country separately. The second and the third column stand for the incentives applied, while the fourth one refers to the period of application. The last column, states the time period which was characterized by major reforms in the fiscal policies.

	Tax Incentives	Other Incentives	Reforms Started	Main Changes
Albania	Local Tax System Law (Law No. 9632)	Doing Business Indicators	1998	2005 – 2007
Kosovo	Corporate Income Tax Law (Law No. 03/L-113) Articles: 15, 21, and 26	Doing Business Indicators	1999	2005
Macedonia	Law on income tax (74/2006, 160/2007) Law on personal income tax (74/2006, 160/2007) Law on value added tax (44/1999, 114/2007, 103/2008) Law on property taxes (61/2004, 102/2008) Law on the amount of default interest rate (65/1992) Law on communal fees (61/2004; 92/2007)	Doing Business Indicators	1990	2006 – 2008
Serbia	Corporate Income Tax Value Added Tax Personal Income Tax Social Insurance Contributions Customs Duties	Doing Business Indicators	1999	2004-2007

[6] Worldwide Tax, *"Taxes and Investment Incentives in Serbia"*, p.2.

Literature review

FDI are an important element of the development process for a country, more specifically a crucial part of the total investments made. They are perceived as crucial elements which initiate an increase in the efficiency of an economy and thus initiate economic growth within a society. This section of the paper will provide definitions and forms of TI and FDI. Further it will explain the relationship between these two variables then it will be concluded by sharing the general perceptions of economists on this relationship.

Definition of Tax Incentives

Since TI are used worldwide, there are given different definitions adopted to the local levels of usage. As stated in the introduction section of this paper, the term TI refers to certain tax reduction applied by the governments to achieve a certain goal. A widely accepted definition of TI is that they are “a deduction, exclusion, or exemption from a tax liability, offered as an enticement to engage in a specified activity (such as investment in capital goods) for a certain period.[7]” Another definition of TI describes them as: “tax benefits offered in order to encourage or discourage targeted activities.[8]”

Types of Tax Incentives

TI are planned and adopted in different ways and forms. They are usually adopted as country-specific fiscal instruments, which are designed to improve the economic performance of a certain country. The most commonly used categories of TI are: tax holidays, investment allowances and tax credits, general tax reductions, and non-income tax –based incentives.

[7] Business Dictionary, *“Tax Incentive”,* nd., par.1
[8] Your Business Dictionary, *“Tax Incentive – Business Definition”,* nd., par.1

Tax holidays

Tax holidays are forms of TI which are applied to the new domestic and foreign investors. The benefits that the investor has from this kind of TI are presumed during the initial stage of the new investment made. The time length of this initial stage depends on the type and volume of the investment, and is usually regulated by law. Beneficiaries of tax holidays can be individuals as well as companies. In most of the cases individuals are usually released from their income tax, while business are given a CIT holiday.[9]

Investment allowances and tax credits

Investment allowances and tax credits are another form of TI which are set based on the value of expenditures made on setting the final investment. Moreover, "this is a tax relief based upon the value of expenditure on qualifying investments. They provide tax benefits that are over and above the depreciation allowed for the asset.[10]"

General tax reductions

General tax reductions are forms of TI which are applied to the new-entering and pre-existing firms in the market. Unlike tax holidays, general tax reductions do not have a time limit attached to their application[11].

Non-income tax-based incentives

Non-income tax-based incentives are forms of TI that apply to inputs used from businesses like custom duties, turn over taxes, and taxes on imported capital etc.[12]

[9] Ngowi, H. P. (0). "*Tax Incentives for Foreign Direct Investments (FDI): Types and Who Should/Should Not Qualify in Tanzania." N.d., p.22*

[10] Ngowi, H. P. (0). "*Tax Incentives for Foreign Direct Investments (FDI): Types and Who Should/Should Not Qualify in Tanzania." N.d., p.23*

[11] Ngowi, H. P. (0). "*Tax Incentives for Foreign Direct Investments (FDI): Types and Who Should/Should Not Qualify in Tanzania." N.d., p.23*

[12] Ngowi, H. P. (0). "*Tax Incentives for Foreign Direct Investments (FDI): Types and Who Should/Should Not Qualify in Tanzania." N.d., p.24*

Definition and classification of Foreign Direct Investment

Foreign Direct Investments (FDIs) are part of the total investment in an economy which refers to the amount of foreign funds invested in a company that performs its business activity in a foreign country. FDI consist of equity investments rather than investments made in stock markets. The reason behind this is the liquidity that stock markets has and the ability to flow that investment out of economy in times of financial troubles.

Based on the direction of money flow, FDI are classified as Inward FDI and Outward FDI. Inward FDI is a type of FDI which is characterized by an investment of foreign capital in local resources. In the other hand, Outward FDI refers to the direct investment which is done abroad and is usually backed by the government.[13]

Relationship between Tax Incentives and FDI

As stated Liu ShuMing (Master in Economics in the University of Nevada), the FDI are important to DC in order to generate economic growth, specifically to those who are "scarce in capital, technology, or far from the efficient production frontier, or have limited managerial and entrepreneurial talents."[14] Having such an importance, countries around the world, especially developing ones have developed different sets of regulations and practices in order to be able to attract more and more FDI. This scenario is also applied among countries of WB which are subject of my paper. Albania, Kosovo, Macedonia, and Serbia have all developed their country-specific strategies to attract higher level of FDIs. Their strategies share the same checklists of requirements.

[13] Definition of Foreign Direct Investment (FDI) | Economy Watch. (n.d.). *World, US, China, India Economy, Investment, Finance, Credit Cards | Economy Watch*. N.d. par.1

[14] ShuMing, L. "*A study of some most important policies for developing countries to attract foreign direct investment successfully"2006, p.12*

All countries of the WB believe that the solution of having more FDI can be found by improving their macroeconomic indicators which are part of the Doing Business Report and also provide a stable financial market by maintaining a stable inflation and exchange rate. In addition, these countries have introduced TI as a form to attract the foreign investors. However, these strategies differ by the priorities given to each instrument. Some countries believe that having a higher rate in Doing Business Report serves as a better attraction for foreign investors, while other believe that taxes play a greater role in this situation. The main question in these situations which strategy fits best and which one to choose? This decision is specific to the country economic and political structure and priorities.

During this research there have been found out that TI represent a following trend of policy making in DC as well. This is seen as an easily understood indicator by the foreign investors and easily applied rule that will bring new investors in Balkans.

In the meantime results of the research on the effectiveness of TI in attracting FDI remain ambiguous. Economists as well as past experience show mixed results. Charls Oman from OECD, discussed the issue of applying different regulations and TI to attract foreign investors. He stated that governments around the world adopt different FI that include tax holidays and specific tax rates applied to specific companies and businesses in order to persuade them to invest in the country. However, the effectiveness of such a policy depends from the development stage of the country which is applying the policy and moreover the ability of the market to absorb this incentive. According to Osman sometimes countries fail to make the right decision because the empirical analysis due to measurement errors fail to portray the reality and thus the decision does not give the expected results.[15]

Another author that discusses the issue of TI is James R. Hines who is a professor at the Michigan Law School. He states that: "reviewing a number of studies, finds that taxation significantly influences FDI inflows although TI mainly play a role only if the other fundamentals are sufficient."[16] The view of Hines is widely spread among economists, because they believe that tax incentive is a good policy which brings results only when other economic indicators and the overall social, political, and economic situations is improving. Contrary to this theory, two officials of the Inter-American Development Bank called Ernesto Stein and Christian

[15] Oman, C., "*Policy Competition for Foreign Direct Investment"2000, p.12*

[16] Hines, JR., *"Forbidden Payment: Foreign Bribery and American Business," 1995,p.8*

Daude argued that "a withholding tax rates on dividends of MNEs suggests that higher tax rates on foreign corporations indeed have a negative effect on FDI. Specifically, a one percentage point increase in the tax rate decreases the stock of FDI by about 4 percent" [17]

Another author that has worked on the issue of FDI attraction and the instruments available is A.J. Easson (Member of Australian Tax Forum). He provides to his reader a better picture on the effect of TI to attract FDI by providing critics toward this debatable topic. Firstly, the author argues that the TI has little or no effect in terms of being a determinant in the decision making process of foreign investors.[18] He analyses the tax system by comparing two potential schemes, the special tax incentive scheme and the general tax regime of the country. By making this comparison the author provides us some arguments against TI. He argues that: Tax incentives are ineffective because they have very little influence upon investment; they are inefficient for the reason that their cost in terms of revenue foregone greatly outweighs any benefit they produce; detrimental as they induce distortions in the form and location of investment. In addition they confer unintended benefits, create local resentment, and generally do more harm than good. [19]

Methodology

The research methodology for this project were planned to be a mixture of primary and secondary qualitative data gathering. This process of data gathering would cover direct and online interviews with government officials, secondary research on libraries and online economic portals.

[17] Stein, E., & Daude, C., *"Institutions, Integration, and the location of Foreign Direct Investment*." 2001, p.5

[18] Easson, A. J. *"Tax incentives for foreign direct investment in developing countries."* 1992, p.2

[19] Easson, A. J. *"Tax incentives for foreign direct investment in developing countries."* 1992, p.4

Primary Research

During my research process I was planning to have an interview with government officials from the Ministry of Economy and Finance and the Ministry of Trade and Industry and head of Investment Promotion Agency of Kosovo (IPAK). These meetings were planned to help me gather primary data about the legislation structure applied by Kosovo institutions in order to make the investment environment more business friendlier for foreign investors. These interviews were not conducted during my research because I was not able to appoint these meetings due to numerous obligations and priory-planned meetings that our government officials had. In addition, an online interview planned with Mr. Kujtim Dobruna - Head of Economic Initiative for Kosovo (ECIKS) which located in Vienna, Austria was also not conducted. Contact with Mr. Dobruna for the online interview started by a questionnaire send by me. The questionnaire had around five questions regarding the TI and FDI in Kosovo. After receiving the email, Mr. Dobruna replied kindly by seeking forgiveness for the inability to conduct an online interview because of time limitations that he had. In reply, he sent me a report written by him in which I was able to find completed answers of my questions.

Secondary Research

The secondary research counts for the biggest portion of my research work done for this project. As part of secondary research, I gathered published material available in the field of economics and legal studies. Additionally, research was made for online books and articles from the online libraries – the RIT Wally Library, official webpage of the ministries of finance of the respective countries from the WB, and other webpage of major worldwide economic and monetary institutions.

Limitations of the data

The data and statistics which I have used for my analysis are generated from the official databases of World Bank. I have decided to use data from World Bank because it is one of few sources where you can find time series data for almost all countries worldwide, and because it remains a uniform statistical source. Despite these facts, please be informed that my honors senior project has certain limitations and assumptions which need to be taken into account when reading this final report. In total there are three main limitations that have influenced the analysis of TI competition among countries of WB, and consequently might have deviate the main findings of this project from the real life situation. These limitations are the inability to build a proper regression analysis, data availability, and data validity.

The first limitation is a result of the assumptions that I have made when making time series analysis in the analysis section of this paper. When calculating the effect that an increase in a variable, being it FDI level, GDP growth, and/or Unemployment rate, I have assumed that the relationship between these variables is linear and I have excluded the other of other independent variables that influence that regression. I have simplified my regression by not taking into consideration the effects that certain situations like war, economic crisis, civil upraises could have on the level of the analyzed variables. Further, I have also generalized the effects that other reforms rather than TI only has on FDI level. Kosovo, Albania, Macedonia, and Serbia have also applied certain regulation to fulfill the EU requirements and have promoted different reforms that are listed to indicators of Doing Business Report. Because of no time series data availability it has been impossible to run a proper regression analysis which will measure the effect of each independent variable separately. Thus, I have assumed that the only reforms that these countries have done are in the field of TI, and that their economic activity was not influenced by the political status which in reality is a typical scenario in the countries of WB.

The second limitation of the authenticity of the project is a result of the lack of time series data. The statistical offices in countries of WB do not apply a proper data gathering process. Data are not always collected in a yearly time manner a problem this which lead in a lack of time series data. Depending on the country, I was not able to generate time series data for all the required independent variables which are part of my analysis. The most problematic countries in providing time series data based on my research were Albania and Serbia. Albania failed to provide time series data on the level of unemployment during the past 20 years, while Serbia failed to provide data on the level of FDI for years 2005-2008.

The third limitation that could influence the accurateness of this analysis is the validity of data. The problem of data validity is a characteristic of all countries which are part of analysis, with an exception of Macedonia in some cases. Data which come from the official World Bank database have are different compared to those reported by the national statistical offices. Sometimes, these mismatches are in reporting happen because of two main reasons. Firstly, the national statistical offices do not usually update their data continuously. Secondly, data and statistic are sometimes manipulated by the government officials in order to increase the level of progress achieved during their governance.

Foreign Direct Investment in Countries of Western Balkans

Albania

Albania is a country of WB which has used taxes and fiscal policies as an incentive to foreign investors. According to a report published by the Ministry of Economy, Trade, and Energy the Government of Albania has adopted some major changes during 2005-2007 in order to make the investment climate more attractive to foreign investors. These fiscal reforms are mostly made under the Law on Local Tax Systems (Law No. 9632) and include the following TI:

- *Reduces business tax from 23% to 20%*
- *Unification of simplified tax profit and tax for small business as defined in the law "On local tax system", no. 9632, dated 30.10.2006. Under this law, the local government is now responsible for the collection of the new tax*
- *Reduce the tax burden paid by the employee social insurance from 29% to 20%*
- *Reduce electricity fee for businesses by 30%*
- *Exemption from taxes on dividends relating to investment*. [20]

The adoption of investment incentives, being them fiscal or other, sometimes has been subject to political changes that happened in Albania. An example of this practice is the introduction of the

[20] Baruah, N. "Remittances to least developed countries (LDCs) issues, policies, practices and enhancing development impact." 2006, p.7

so-called initiative “Albania 1 Euro”. This initiative was firstly introduced in Albania by the Democratic Party during the elections campaign in 2005. Mr. Berisha, head of the Democratic Party in Albania promised the citizens that one of his major goals if being selected is to increase the domestic and foreign investments in Albania. The elections of 2005 in Albania were won by the Democratic Party, thus Mr. Berisha started to prepare for the fulfillment of his pre-electoral promises. Following this path, one year later on September 2006, the Government of Albania introduced its initiative “Albania 1 Euro” which seeks to increase the level of domestic and foreign investments in Albania thus directly increasing the level of employment. By the time when this initiative was promoted Mr. Berisha declared: “We will continue our efforts to make Albania a cheaper and better country for domestic and foreign investors.” [21]By the adoption of this initiative the Government was committed to provide to domestic and foreign investor land, qualified employees, technological water, business registration, entry in Albania, and other services with a cost of one euro only per meter square. According to Gabriel Partos who is a BBC analyst for South-Eastern Europe, “This proposal sounds like a very ambitious initiative and I do not think there was any identical scheme in other countries. There have been similar ideas to attract foreign investors and the most popular among them was providing a tax-free period.” [22]

Kosovo

After the end of the war, Kosovo had a huge flow of capital in the form of foreign aid, especially in the first four years. During these years we didn’t have lots of FDIs since Kosovo was a post-conflict country which lack the legal frame and economic stability that is required by the foreign investors to invest here. Moreover, the existing legal framework was determined by foreign resolutions which left no room for intervention of the Ministry of Finance to introduce TI which would probably improve the level of FDI in Kosovo. Another factor that highly influenced the attraction of FDI in Kosovo is the political instability, which is manifested by the engagement of

[21] BBCAlbanian, *“Qeveria shpall'Shqipëria një euro”,* 2006, p.3
[22] BBCAlbanian, *Gabriel Partos: Shqipëria një euro, iniciativë ambicioze*. 2006, p.4

high political officials in corruption affairs. Based on the data available, the FDI in Kosovo appear to have a decreasing trend.

Kosovo has changed their initial tax schemes in 1999/2000 under the administration of UN, a moment this that marked the separation of fiscal policies from the ex-Yugoslav Federation. For thirteen years up to know, Kosovo has gradually evolved in adopting new rules and regulations as part of its fiscal policy in order to create a more investment friendly environment. In addition to these rules, the Republic of Kosovo has established an institution called Investment Promotion Agency of Kosovo (IPAK) which is directly responsible for the promotion of Kosovo among the foreign countries and potential foreign direct investors.

As part of an ongoing process to attract foreign direct investors, Kosovo has modified some of its fiscal rules in order to make the investment environment friendlier to the domestic and foreign investors as well. Under the TI, the Government of Kosovo has introduced three main practices under the law on CIT (Law No. 03/L-113) [23].

Article 21 under Law 03/L-113 on CIT, regulates the business loss of a company. The second part of this article states that: "The amount of the business loss determined under this Article may be carried forward for up to seven (7) successive tax periods and shall be available as a deduction against any income in those years." [24]

The second practice which is considered as a tax incentive by the Institutions of Kosovo refers to the new assets and special allowances which are subject to them. Article 15 of the Law on CIT states the allowances that are made to companies when purchasing new assets. According to this article: "If a taxpayer purchases any asset belonging to Category 3 for the purpose of the taxpayer's economic activity between 1 January 2005 and 31 December 2008, a special deduction of ten percent (10%) of the cost of acquisition of the asset shall be allowed in the year in which the asset has been first placed into service. This deduction shall be in addition to the normal allowable depreciation deduction." Furthermore the article states that this deduction will be applied only and only is this asset is newly purchased or is used for the first time within the territory of the Republic of Kosovo[25].

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[23] Central Bank of Kosovo. "*LAW NO.03/L-113 ON CORPORATE INCOME TAX* ", 2008, par. 3

[24] Central Bank of Kosovo. "*LAW NO.03/L-113 ON CORPORATE INCOME TAX* ", 2008, par. 26

[25] Central Bank of Kosovo. "*LAW NO.03/L-113 ON CORPORATE INCOME TAX* ", 2008, par.20

The third tax incentive under the law on CIT corresponds to the practice of DT. Under the first part of the Article 26 on DT, “A resident taxpayer who receives income from business activities outside of Kosovo through a permanent establishment outside of Kosovo, and who pays tax on that income to any State, shall be allowed a tax credit under this Law in an amount equal to the amount of tax paid to such State.” Additionally, the third part of this article states that in case when there is a bilateral agreement on avoidance of DT with any country, rules agreed on it will preserve the provisions stated by this article (Article 26)[26].

Macedonia

Macedonia is another country located in the Balkans, which has also adopted TI to attract more FDIs. The economy of Macedonia, same as others in Balkans, experienced a transition phase to capitalism which started in 1990s and continued for more than a decade until the membership of Macedonia in the World Trade Organization in April 2003[27]. During this decade the policy makers has been devoted in adopting new fiscal rules which would transfer the economy and economic activity from a centralized one as under the Former Yugoslavia to a market oriented one. By introducing market oriented economic rules, the authorities in Macedonia seek to create an investment friendly environment to both domestic and foreign investors. In fact, the key to a successful transition of Macedonian economy was the equal treatment that it provided for both the domestic and foreign investors.

Significant changes in terms of tax legislation are made in several laws in Macedonia. Laws like law on income tax (74/2006, 160/2007), law on personal income tax (74/2006, 160/2007), law on value added tax (44/1999, 114/2007, 103/2008), law on property taxes (61/2004, 102/2008), law on the amount of default interest rate (65/1992), and law on communal fees (61/2004; 92/2007) were changed by adopting more market friendly policies and lower tax rates. [28]

[26] Central Bank of Kosovo. “*LAW NO.03/L-113 ON CORPORATE INCOME TAX* “, 2008, par.31
[27] Dimireva, I. “*FYR of Macedonia Investment Climate*”, 2008, par. 2
[28] Dimireva, I. “*FYR of Macedonia Investment Climate*”, 2008, par. 8

During the election campaign for the elections of 2006, the Democratic Party for Macedonian National Unity leaded by Nikola Gruevski promised to introduce a flat-tax rate on income and profit tax. In this way the new potential government would increase the wealth fare of the citizens of Macedonia and make the market for investments friendlier. After winning the elections, Prime Minister Nikola Gruevski introduced the first change in the tax system in January 2007 by decreasing the profit tax rate from 15% to 12%. In addition a new flat income tax rate of 12% was introduced[29]. One year later, in January 2008, the profit tax rate experienced a second decrease from 12% to 10%[30]. According to the government officials who were in charge of fiscal policies, these changes were undertaken because they were planned to have a positive impact on the economy. These positive impacts would consist of a more efficient tax collection and an increased level of FDI. [31]

These changes were followed by an internal pressure on the adoption of the new fiscal policies, which were caused by a drop in the overall decrease of tax revenues in Macedonia. Another tax incentive adopted by Macedonian Authorities is the tax exemption that is applied for the reinvestment of the income.

Finally, as part of the fiscal reforms, Macedonia has signed contracts that ensure the avoidance of DT in the investments made in services and the stock exchange. By signing the contracts on the avoidance of DT Macedonia agrees to apply the same tax treatment to a foreign investor, as in their initial country of residence. Moreover, these contracts specify the right and obligations of the signing parties (countries) in terms of tax payment and collection. Countries which have already signed an agreement to avoid DT with Macedonia are: Albania, Sweden, Ukraine, Slovenia, Croatia, Turkey, Poland, Italy, China, Russia, Netherlands, Bulgaria, France, Taiwan, Egypt, Denmark, Switzerland, Romania, Czech Republic, Iran, Finland, Hungary, Belorussia, Spain, Moldavia, United Kingdom and Northern Ireland, Latvia, Germany and Austria.[32]

[29] Nikolovski, Z. *"Macedonia introduces flat-tax rate*", 2007, par 1
[30] Nikolovski, Z. *"Macedonia introduces flat-tax rate*", 2007, par 2
[31] Nikolovski, Z. *"Macedonia introduces flat-tax rate*", 2007, par 3
[32] Dimireva, I. "*FYR of Macedonia Investment Climate*", 2008, par. 23

Serbia

Serbia is another WB country which is part of my analysis on TI as a way to attract FDIs. After the breakdown of Yugoslavia in 1999, Serbia started reforms to adapt to the new economic order in Balkans. Once a centralized economy, now Serbia needed to undertake certain reforms that will create a free economic market which would be attractive to new domestic and foreign investors. During this period Serbia has adopted changes in five laws which regulate the fiscal performance. These laws are: Law on CIT, Law on Value Added Tax, Law on Personal Income Tax, and Law on Custom Duties. In order to promote Serbia as a good destination for potential foreign investors, Serbia Investment and Export Promotion Agency (SIEPA) has identifies the TI that are offered by the Serbian Government to investors who will invest their capital and employ people within the Serbian territory.[33]

Firstly, under the Law on CIT, the Government of Serbia has approved to make some tax releases like: a 10 year tax holiday for investment over €9 million with more than 200 new employees, a 5year tax holiday for investment in underdeveloped regions, and a 5 year tax exemption for concession investment. Furthermore, it has adopted tax reductions for investment in fixed assets up to 80% of the investment amount and signed 42 DT Treaties to avoid DT. Additionally, tax losses stated in the tax return can be carried forward and offset against future profits over a period up to 5 years. [34]

Secondly, under the Law on Value Added Tax, the Government has offered tax exemptions for commercial activities within the Free Zones. Free Zones can be also privately-established by the foreign investors by taking a prior approval by the Government officials. Currently there are six Free Zones within Serbia which benefit from the tax exemption on VAT: Novi Sad, Kragujevac, Subotica, Pirot, Zrenjanin and Sabac. In the meantime three other in Nis, Smederevo and Uzice are being prepared for legalization.[35]

Thirdly, the Law of Personal Income Tax has been adopted as an auto-generator of employment for certain sensitive labor categories like disabled and/or structurally unemployed people under

[33] "Investment Incentives." (n.d.). *par. 1-2*
[34] "Investment Incentives." (n.d.). *par. 2*
[35] "Investment Incentives." (n.d.). *par. 3*

30 or above 50. In these cases, if you as an employer decide to employ an employee that belongs to these categories you will be exempt from paying social insurance and salary tax for those employees in a period of 2-3 years.[36]

Fourthly, the modifications in the Law on Custom Duties promote the free imports of raw materials and equipment. Further, according to this law the import of construction materials in the Free Zones is also exempt by tax of imports.[37]

Analysis on Tax Incentives and FDI Level of Western Balkan Countries

As introduced in the literature review section, all countries of WB which are part of this analysis have adopted different kinds of TI. These adoptions in the tax legislation were mainly as a response to the regional and worldwide competition in attracting more FDI. Secondly, these adoptions were planned to contribute to further economic development. The economic performance has become a major challenge for the elected government representatives of countries of WB through years. Kosovo, Albania, Macedonia, and Serbia have not achieved a desired economic performance during the last decades of the 20th century. Moreover, the situation got worse by the social and political unrest which were initiated either by the political suppressions and/or economic misery. Being challenged by the social movements, the government officials of all Western countries were always pushed forward to make changes that will improve citizens' life by stimulating economic growth which would be reflected in an increase in GDP and consequently a decrease in the unemployment rate.

Pressured by the electorate for the above mentioned reasons, parties that run for elections have always identified economic growth and employment as their main goals and TI as an instrument to achieve them. Thus, they have always proclaimed their initiatives to lower taxes and make the

[36] "Investment Incentives." (n.d.). *par. 4*
[37] "Investment Incentives." (n.d.). *par. 4*

market friendlier for domestic and foreign investors. The expectations and promises of the elected government candidates are measured below by making three cross analysis among three important economic indicators like: GDP, Unemployment Rate, and FDI. Firstly, the analysis will start by measuring the relation between tax incentive adoptions and the level of FDI. The next analysis will be made on the link between the level of FDI and GDP Growth. Finally, a third analysis on the relationship of the level of FDI with the unemployment rate was conducted.

Tax Incentives vs. FDI Level

TI and FDI level has a positive relationship. This is the widely expected result on which the government officials of WB believe when they introduce TI as an instrument to boost the economic development in their countries. In order to verify whether this belief of government officials is true, I have made a country specific analysis which in general shows mixed result. If we discuss about the effectiveness of TI in Kosovo, we can argue that based on data available there has been a positive relationship by which and introduction of tax incentive in 2005 has led to an increase in FDI level in the next couple of years. This increase in FDI was followed by a 3% point decrease in 2009, and the reason behind it could be the worldwide financial crisis.

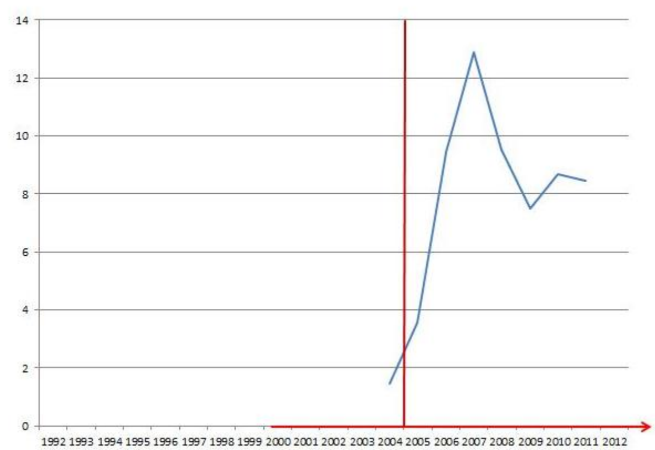

Figure 1 - Tax Incentives VS FDI Level in Kosovo

Based on avaliable statistics, a same situation has also happened in Albania. Albania made its first steps toward introducing fical policies in 1992; however, its performance was interrupted by the social upsireses in 1997 and Kosovo War in 1999. A major change in Albania's fiscal policies happened between 2005-2007, and this led to a major increase in the level of FDI in the next three years. Same as in Kosovo, after 2007 FDI levels in Albania has also experienced a decrease by 2% points.

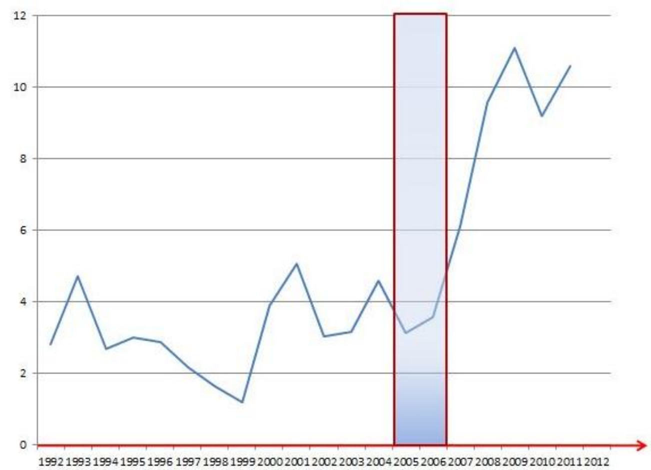

Figure 2 - Tax Incentives VS FDI Level in Albania

Oppositely to Kosovo and Albania, Macedonia has experienced a different situation. In this country the data show that there was no positive relationship between the introduction of TI and the level of FDI. The level of FDI has experienced a fluctuating trend with critical ups and downs. Macedonia started its fiscal reforms in 1992, while it introduced the biggest package of TI during 2006-2008. Despite these changes it failed to give positive results in increasing FDI levels. Starting from 2007, Macedonia experienced a three year period of decrease in FDI which in total counts for 6.5% points.

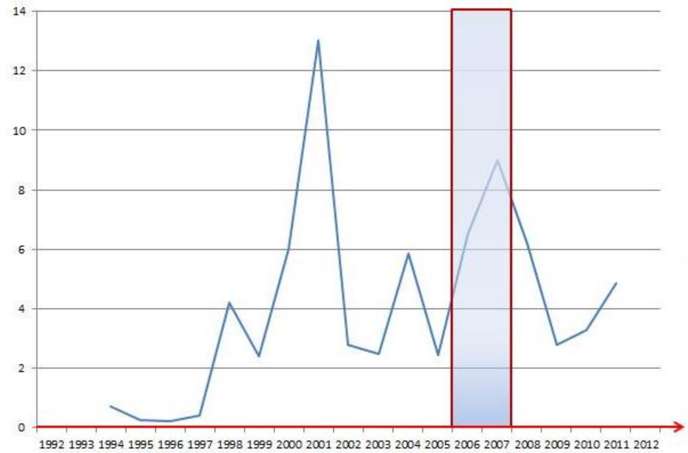

Figure 3 - Tax Incentives VS FDI Level in Macedonia

A different situation happened in Serbia. During the war in Kosovo, Serbia has experienced the most rapid decrease in its FDI levels. They reached the lowest point of only 0.5 in 1999. After the end of the war in 2000, Serbian Government started to rebuild its fiscal policy by adopting TI which seemed to be successful since they lead to an increase of 6.5% points in FDI levels up to 2003. Then Serbia experienced a second drop, which was followed by a three-year period during which there was a lack of the reported data. In general, the FDI in Serbia has experienced a fluctuating trend with great peaks and critical troughs followed by a lack of data for certain years.

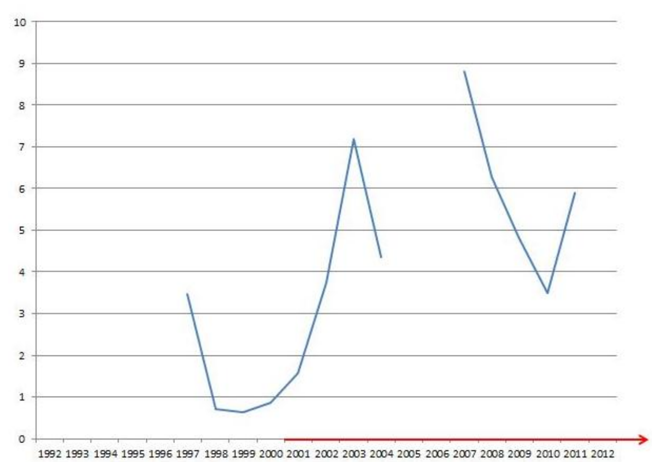

Figure 4 - Tax Incentives VS FDI Level in Serbia

FDI Level vs. GDP Growth

In this second analysis, I have decided to test the hypothesis believed by the government officials that FDI level has a positive relationship with GDP Growth. Based on the analysis which was made with the data provided by the World Bank, I can argue that there is a positive relationship between FDI Level and GDP Growth. The results show almost the same scenario for all four countries: Kosovo, Albania, Macedonia, and Serbia. Fluctuations in the FDI Level were followed by a fluctuation in the GDP Growth and vice versa. These fluctuations were reflected mostly in the same year with no time shift. Sometimes the results were felt in the following year with a half or full year time shift. An exception is made in cases when there were critical shocks, being them increased or decreased. In these cases the fluctuations in one variable does not reflect immediately in the other variable. Examples of these sharp fluctuations are usually experienced in periods and immediately after wars and civil unrest, like in Kosovo (2001), Albania (1993 & 1998), and Serbia (1999). The relationship in fluctuation of FDI level and GDP Growth are shown in the graphs below. The red line portrays the GDP Growth, while the blue line represents the FDI level.

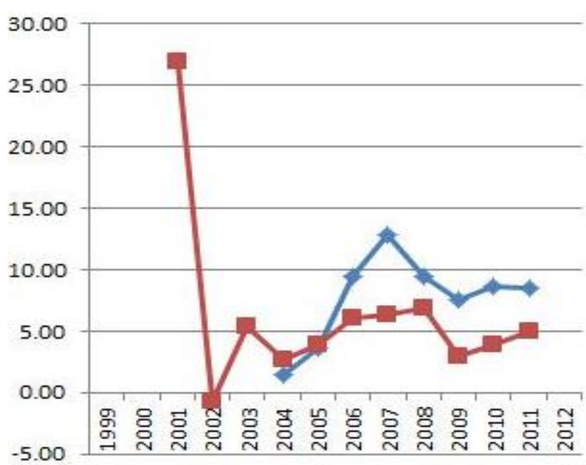

Figure 5 - FDI Level VS GDP Growth in Kosovo

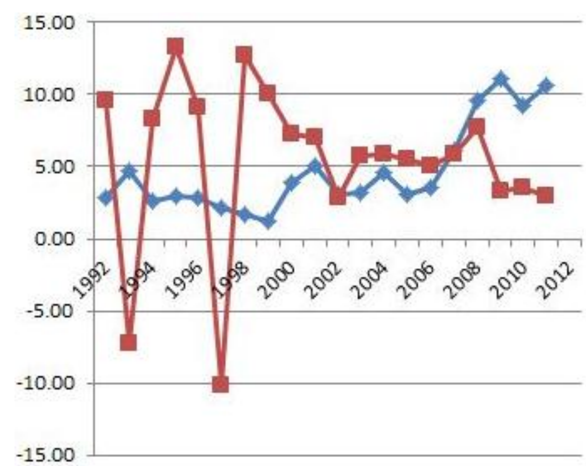

Figure 6 - FDI Flow VS GDP Growth in Albania

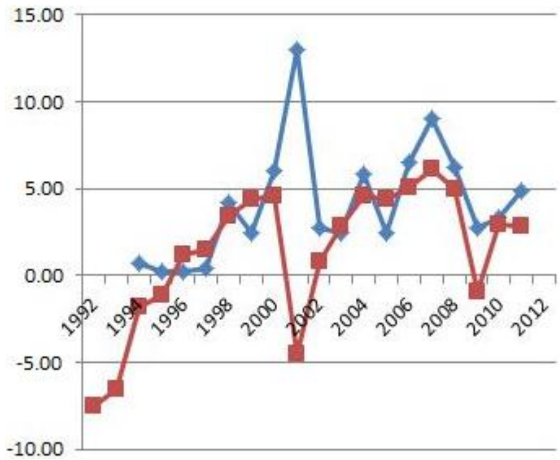

Figure 7 - FDI Flow VS GDP Growth in Macedonia

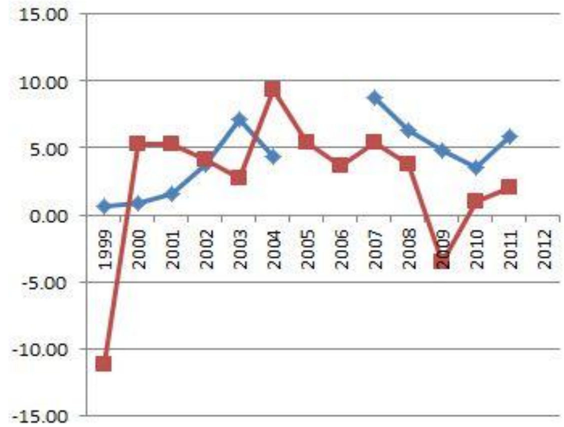

Figure 8 - FDI Flow VS GDP Growth in Serbia

FDI Level vs. Unemployment

The third analysis seeks to identify the relationship between FDI Level and the Unemployment Rate. The reason behind this analysis is to test whether there is a negative relationship between these two variables, as government officials believe. The overall belief regarding the relationship between these two variables is that more FDI will lead to a lower unemployment rate. The general trend generated by the data available illustrates three different scenarios. The first and the widely accepted one is the one which shows that the negative relationship foreseen by economists for these two variables, exist in reality in some countries of WB like Kosovo and Macedonia. Macedonia is the best example which illustrates the negative relationship between FDI Level and Unemployment. As you can see in the graph below, the fluctuations of these two variables are made in the opposite direction. For example, in Macedonia we had an increase in the level of FDI during 1997 to 2003. This increase in FDI was followed by a decrease in the level of unemployment. Further a decrease in the level of GDP was followed with an increase in the unemployment rate during 2003 to 2006.

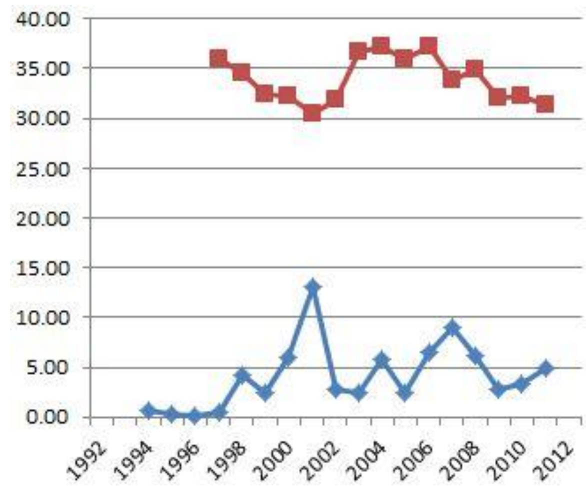

Figure 9 - FDI Flow VS Unemployment in Macedonia

Secondly despite this confirmation, I think that the relationship between FDI levels and Unemployment is hard to be identified since there is a huge inconsistency among the data provided by the official institutions and employment offices. Usually there is a lack of time series data, which makes it impossible to have a proper regression analysis. Such a scenario is projected in the time series data of Albania and Serbia.

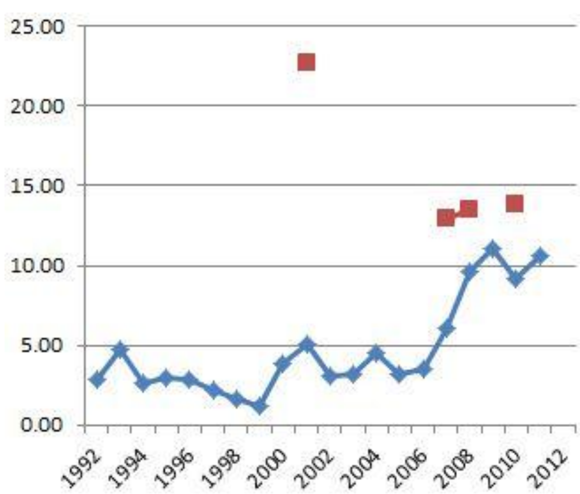

Figure 10 - FDI Flow VS Unemployment in Albania

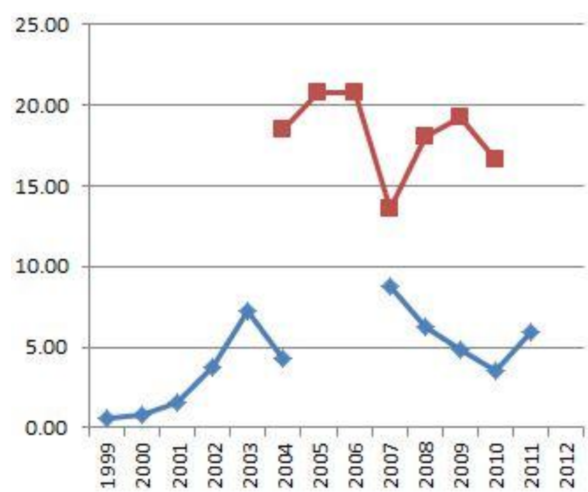

Figure 11 - FDI Flow VS Unemployment in Serbia

Thirdly, if we analyze the Kosovo's case, we can argue that the data provided seem unofficial because we experience around 20% decrease in the unemployment rate from year 2001 to year 2004. Such an economic indicator can be hardly achieved since it requires you to have a great GDP increase by labor intensive FDI investments. In the following year, the data about the level of FDI correspond to a negative shock in the level of unemployment.

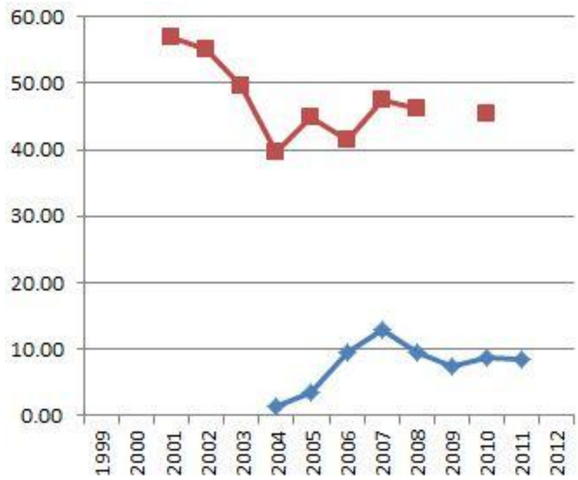

Figure 12 - FDI Flow VS Unemployment in Kosovo

Cross-Country Analysis

Conducting an analysis based on the effect of FDI in the GDP Growth and Unemployment rate has enabled us to have a clearer picture of the performance of Albania, Kosovo, Macedonia, and Serbia. This section is an extension of the economic analysis in the regional view, more precisely a cross-country analysis. WB countries in this section are compared among themselves based on the achievement made to attract a higher level of FDI since their initial application of TI.

In order to be able to compare these four countries, we should consider using the same economic indicator which applies to them all. Additionally, we need to be sure that there are time series data available for the selected variables since otherwise we won't be able to make a proper cross-country analysis. Following these criteria, two basic economic indicators like

FDI Inflow (in millions of EUR) and GDP (in millions of EUR) were selected. The cross-country analysis was conducted by calculating the level of FDI Inflow as a percentage of GDP for each specific year. Percentages generated per each year served to make a double comparison between countries. Firstly, countries were compared based per year. Secondly, countries were compared based on an average percentage calculated for the whole period during which TI were applied.

Based on the first analysis, which was conducted by calculating the percentage that FDI Inflow has on GDP of each state in millions of Euros, we can conclude that data differ among countries. Below you can see a table which summarizes the calculated percentages per year per each country. Based on the highest value, I have made a yearly ranking of the most successful country in attracting FDI. This yearly ranking is listed in the sixth column of the table below.

Year	Albania	Kosovo	Macedonia	Serbia	Most Successful Country
1992	2.82%				Albania
1993	4.72%				Albania
1994	2.67%		0.71%		Albania
1995	2.89%		0.21%		Albania
1996	2.99%		0.25%		Albania
1997	2.16%		0.42%	3.46%	Serbia
1998	1.65%		4.21%	0.70%	Macedonia
1999	1.20%		2.41%	0.64%	Macedonia
2000	3.88%		6.00%	0.85%	Macedonia
2001	5.07%		13.01%	1.56%	Macedonia
2002	3.03%		2.78%	3.76%	Serbia
2003	3.15%		2.48%	7.19%	Serbia
2004	4.57%	1.46%	5.86%	4.35%	Macedonia
2005	3.13%	3.58%	2.43%		Kosovo
2006	3.56%	9.44%	6.52%		Kosovo
2007	6.09%	12.90%	8.99%	8.81%	Kosovo
2008	9.57%	9.51%	6.22%	6.27%	Albania
2009	11.08%	7.49%	2.79%	4.82%	Albania
2010	9.19%	8.70%	3.22%	3.49%	Albania
2011	10.57%	8.47%	4.74%	5.89%	Albania

The ranking of the above table shows that based on available data, Albania has performed better in attracting higher levels of FDI per certain years compared to its neighboring countries. Specifically, Albania has been the most successful country in attracting FDI in two main periods; firstly between 1992-1996, and secondly between years 2008-2011. The second most successful country is Macedonia. Finally, Kosovo and Serbia have managed to attract more investments during three years.

A final ranking was made based on the average score for the period 1992-2011. Based on this scaling, Kosovo is the most successful country in the region in attracting FDI by being able to generate 5.13% of its GDP (in current Euro) by FDI. The second country is Albania (4.70%). Macedonia (3.66%) is ranked in the third place, and finally Serbia is ranked in the bottom of the list by 3.45%.

Conclusions and Recommendations

Based on the analysis made on the effectiveness of TI on increasing economic performance by previously increasing the level of FDI, I can argue that their effectiveness depends on the political and economic situation of the country itself. Moreover, their effect appears different in trying to achieve different outcomes of different variables.

For example, if the primary purpose of government officials is to achieve a higher stage of economic development by increasing their GDP than applying TI could be a useful instrument. In general the analysis has shown that TI have a positive relationship with GDP growth; however, they failed to smooth the negative shocks and spillover effects experienced by an economy in times of war or economic and financial crises. Normally, when an economy is in its expansion phase, then the FDI levels tend to increase with or without the promotion of TI. Foreign investors usually are more interested to the scale of return on profit, rather than the amount of taxes that they need to pay. Compared to statistics, the practice has shown that higher level of FDI does not necessarily lead to an economic growth. Most of the times an increase in the level of FDI is mostly a result of reforms within the indicators of doing business, rather than TI only. In DC like Kosovo, Albania, Macedonia, and Serbia, a mixture in the promotion of doing business indicators would be the best solution in order to economic growth or smooth the negative shock from the world financial crisis. The ability of foreign investor to generate more economic growth depends on their decision to purchase a property in a country and/ or invest further to use it. For example if a foreign investor decides to purchase a factory and do nothing more, than it does not lead to a higher GDP growth because we only have a transfer on property rights. However, if the same investor decides to establish a company or produce something than it leads to an increase in GDP because it employs additional workers and purchase raw materials needed to continue its production or service. The table below shows the mix of results shown by the statistics for these four countries of WB, by assuming a continuous increase in the promotion of TI.

	FDI Inflow	GDP Growth	Doing Business Ranking
Albania	Increase	Decrease	Increase
Kosovo	Decrease	Increase	Decrease
Macedonia	Increase	Decrease	Increase
Serbia	Increase	Increase	Decrease

Secondly, if the main purpose of the government officials when promoting TI is to achieve more employment rather more GDP growth than they should primarily get familiar with the nature of investment. For example if the investments brought as a result of TI offered to the investor is labor intensive, then they would have a strong argument in supporting their decision to adopt TI. However, if the investment made as a result of TI is capital intensive then there is no need for the promotion of TI. In these cases the solution might be a mixture of incentives in doing business indicators or other in-kind incentives.

Apendixes

Appendix A

Appendix A shows the level of FDI Net Inflow as percentage of GDP in countries of WB.

FDI Net Inflow (% of GDP)				
Year	Albania	Kosovo	Macedonia	Serbia
1992	2.82			
1993	4.72			
1994	2.67		0.71	
1995	2.99		0.25	
1996	2.89		0.21	
1997	2.16		0.42	3.46
1998	1.65		4.21	0.70
1999	1.20		2.41	0.64
2000	3.88		6.00	0.85
2001	5.07		13.01	1.56
2002	3.03		2.78	3.76
2003	3.15		2.48	7.19
2004	4.57	1.46	5.86	4.35
2005	3.13	3.58	2.43	
2006	3.56	9.44	6.52	
2007	6.09	12.90	8.99	8.81
2008	9.57	9.51	6.22	6.27
2009	11.08	7.49	2.79	4.82
2010	9.19	8.70	3.29	3.49
2011	10.57	8.47	4.87	5.89
2012				

Appendix B

Appendix B summarizes the GDP Growth as an annual % in countries of WB.

GDP Growth (annual %)				
Year	Albania	Kosovo	Macedonia	Serbia
1992	9.60		-7.47	-30.51
1993	-7.20		-6.56	-27.16
1994	8.30		-1.76	2.50
1995	13.30		-1.11	6.10
1996	9.10		1.18	7.80
1997	-10.20		1.44	10.10
1998	12.70		3.38	0.70
1999	10.10		4.34	-11.20
2000	7.30		4.55	5.34
2001	7.00	26.97	-4.53	5.30
2002	2.90	-0.70	0.85	4.12
2003	5.70	5.42	2.82	2.67
2004	5.90	2.61	4.63	9.30
2005	5.50	3.84	4.35	5.40
2006	5.00	6.00	5.03	3.60
2007	5.90	6.30	6.15	5.40
2008	7.70	6.90	4.95	3.80
2009	3.30	2.90	-0.92	-3.50
2010	3.50	3.90	2.89	0.95
2011	3.00	5.00	2.84	2.00
2012				

Appendix C

Appendix C summarizes the Unemployment rate in countries of WB.

Unemployment (% of labor force)				
Year	Albania	Kosovo	Macedonia	Serbia
1992				
1993				
1994				
1995				
1996				
1997			36.00	
1998			34.50	
1999			32.40	
2000			32.20	
2001	22.70	57.00	30.50	
2002		55.00	31.90	
2003		49.70	36.70	
2004		39.70	37.20	18.50
2005		44.90	36.00	20.80
2006		41.40	37.30	20.80
2007	13.00	47.50	33.80	13.60
2008	13.50	46.30	34.90	18.10
2009			32.00	19.20
2010	13.80	45.40	32.20	16.60
2011			31.40	
2012				

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