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COMPARATIVE ANALYSIS OF FDI INCENTIVES IN NEW EU MEMBER STATES

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ABSTRACT. ***The study discusses issues related to a host country's incentives used to attract foreign direct investment in the new EU countries. The aim of the research is to ascertain and compare investment incentives to attract foreign investment in different countries. The main tasks of the paper are to explore the application of FDI incentives and to assess their impact on investment volumes. The research is based on three step methodology that reflects first the scope and composition of incentives, attractiveness of FDI incentives as perceived by MNCs, and the view of experts on incentives in Lithuania. The research revealed that FDI has no linkages with the scope of FDI incentives offered by a host country. It was also confirmed that financial incentives have a greater impact than fiscal incentives or special economic zones (SEZs) on an investor's decision.***

KEYWORDS: foreign direct investment, financial incentives, fiscal incentives, special economic zones, the EU.

JEL classification: F2, P2.

Introduction

Thirty years ago numerous countries tried to safeguard their domestic markets from foreign investors therefore investment promotion was not among top government priorities. Nowadays due to free capital movement throughout the global economy and market integration the attitude toward foreign direct investment (FDI) changed considerably. Countries have liberalized their policies to attract more investments; however, it is no longer sufficient just to liberalize its FDI regime because most of the economies have already done it. Policy makers need to move beyond the idea of attracting FDI with the lure of cheap labour and tax incentives. The relevancy of FDI's stimulus issue is obvious especially in the presence of economic crisis causing a sharp decline in FDI in both the EU and worldwide when governments are impelled to overview and revaluate their investment polices and incentive schemes. The paper discusses issues related to the host country's incentives to attract FDI in new EU member states (NMS) except Malta and Cyprus. The aim of the paper is to ascertain and compare investment incentives to attract FDI granted by different NMS.

1. Theoretical Aspects of FDI and Incentives

FDI is defined as "the objective of obtaining a lasting interest by a resident entity in one economy ("direct investor") in an entity resident in an economy other than that of the investor ("direct investment enterprise"(Balance of Payments, 1993; Detailed Benchmark, 1996). The most important characteristic of FDI is the exercise of control over an enterprise that cannot be less than 10% of the ordinary shares or voting power of an enterprise. FDI can be made as a greenfield investment which starts from a scratch and aims at direct financial inputs to establish a presence in new market. Usually profits from such investment return to a home country and it is slow to establish. Mergers and acquisitions is another form of FDI combining two companies when one corporation is absorbed by another. The majority of FDI is in this form because it can help to reach economies of scale, increase market share and sales. FDI are driven mostly by transnational corporations which are regarded as enterprises comprising entities in more than one country. FDI includes all initial and subsequent transactions between two entities and affiliated enterprises.

Horizontal FDI duplicates similar activities in foreign countries and are performed in order to serve a local market better and to reduce the costs. Vertical FDI is a location of different stages of production in different countries to reduce input costs for different phases of the production process (Navaretti and Venables, 2004). Horizontal FDIs have a higher technology level and a higher spillover effects than vertical FDIs, on the other hand, countries will typically attract the type of FDI that is most beneficial given their level of development (Roording and Vaal, 2010). In reality most FDI is horizontal and even horizontal FDI aimed at serving local markets have vertical FDI characteristics (IMF, 2003).

1.1 FDI Implications for the Host Economy

Through dissemination of spillovers to domestic economy FDI can help to expand host economy, drive job creation and income growth, create more competitive business environment or contribute to trade expansion. Blomström and Kokko (2003), Navaretti and Venables (2004) found that FDI may lead to positive externalities in the form of technological or knowledge spillovers that can justify the actions of governments to increase FDI inflows.

Spillover effects can be described as externalities of the foreign investor's activity or processes upon those who are not directly involved in it. Spillover effects might be horizontal when domestic companies learn from foreign investors through cooperation, employees' alteration, and common projects or vertical when companies from adjacent industries (suppliers, customers) learn from a foreign company and increase their efficiency. The studies of FDI spillovers in NMS revealed their existence both within and across sectors. The former arise when foreign firms operate in labour intensive sectors, while the latter occur when foreign firms operate in high-tech sectors (Nicolini and Resmini, 2010).

The literature identifies technological transfer as a most important positive externality to the host economy. The relationship between FDI and technology transfer is noticeable in Slovak Republic, Czech Republic, Hungary and Estonia (Global, 2009). Furthermore, FDI with newer and cleaner technologies can also have a positive environmental impact. Human capital enhancement can be another implication of FDI for the host economy. According to Navaretti and Venables (2004), multinational enterprises (MNE) pay higher wages, raise employment, hire better skilled personnel. FDI can also spur competition in the host country markets that leads to higher productivity, lower costs and prices, more efficient resource allocation, however, it may also cause concentration in the market.

Opponents of FDI argue that during the first years of investment a sharp economic growth can be noticed, however, when the time passes the capital in a form of profit, dividends begins to flow back to the investor's home country. FDI can lead to uneven economic development when investments are channelled to a particular sector. Another argument of FDI sceptics is that they may have a negative impact on the domestic companies. According to Oman (2000), competition among governments to attract FDI may also create problems because there exists a tendency to overbid and incentives may surpass the level of the spillover benefits. Potential drawbacks can also be the lack of positive linkages with domestic companies, a harmful environmental impact of FDI, especially in extractive and heavy industries, social disruptions of accelerated commercialization (Foreign, 2002). OECD study also disclosed that working conditions in MNEs are not always better than in domestic ones, working hours have been found to be longer in foreign-owned firms (Network, 2009). A recent study on timing of entry on spillovers found that local companies experience positive horizontal effects from majority foreign owned firms, but only in the longer run because they need time and effort to absorb technology. Thus FDI raises the level of local firms' productivity, but the impact depends strongly on its maturity (Merlevede *et al*., 2010).

1.2 Host Country Determinants of FDI

Host country determinants facilitating investment can be divided into three groups: economic determinants, policy framework for FDI, business facilitation and conditions. Economic determinants include all assets possessed by the country which can be used as non-fiscal incentives for attracting FDI and can be influenced by the government policies[1]. In most NMS labour markets are more flexible and efficient than they are in the EU15, especially with respect to regulations related to hiring and firing, the flexibility of wage determination, the relationship between pay and productivity. Recent study showed that foreign investors in NMS are seeking quick and smooth technological transfer and hence value the level and

[1] They encompass the market size and per capital income; market growth; access to global and regional markets; structure of markets; country-specific consumer preferences; raw materials; physical infrastructure; skilled/low cost unskilled labour; technological and innovatory assets; cost of resources and assets; other input costs; membership in regional agreements.

quality of human capital (Talpos and Enache, 2010). Physical infrastructure, however, is one of the weaknesses of the region (Global, 2009).

Country's economic and political stability associated with fixed exchange rates along with EU membership have an impact of FDI inflows also (Global, 2009). The EU accession helped to attract more efficiency-seeking, export-oriented FDI, complete FDI liberalization, raise standards for FDI and reduce the risk for foreign investors majority of which come from the EU. "World Investment Prospects Survey 2009 – 2011" (World Investment, 2009) demonstrates that though trade liberalization was expected to diminish the importance of domestic market size, the presence of suppliers and partners, the access to international markets and business-friendly environment are the leading factors influencing the location of companies.

Regulatory and legal policy framework for FDI[2] of the host country matters for FDI as well. To be attractive it should be sound, clearly defined, flexible, transparent, and predictable. NMS became attractive to foreign investors because of opening formerly closed markets, however, they do not reach the average level of the EU15 with respect to the quality of public institutions (corruption, bureaucracy, low public trust in politicians). Regulatory framework in NMS can be compared using FDI Restrictiveness Index covering (i) foreign equity restrictions, (ii) screening and prior approval requirements, (iii) rules for key personnel, and (iv) other restrictions on the operation of foreign enterprises. Its update in 2010 shows that Romania (0.008), Slovenia (0.012), Slovak Republic (0.049) and Lithuania (0.050) have less restrictions than Latvia (0.085), Estonia (0.098), Poland (0.111) (closed = 1, open = 0) (Kalinova *et al.,* 2010).

Business facilitation covers investment incentives, hassle costs, social amenities and after investment services and aims at promotion and facilitation of inward FDI (Promoting, 2009). In most countries investment promotion agencies (IPAs) are responsible for investment promotion and coordination. Their tasks include identification of potential investors, investor services, image building, investor generation, and other activities aimed at attracting investors (Cass, 2007). Wells and Wint (2000) found out that the net present value of pro-active investment promotion can be approximately $4 for every $1 spent.

2. FDI Incentives

Economic literature contains very controversial opinions about the role of host country incentives in attracting FDI. Barros and Cabral (2000) argue that FDI incentives can have a significant impact on the pattern of international investment while Villela and Barreix (2002), Hoekman and Saggi (2000) argue that incentives are generally ineffective. Nunnenkamp and Spatz (2002) claim that market-related factors continue to remain a key determinant for inward FDI.

The investment decision of a foreign investor can be affected by an expected profit, the ease with which investor's operations in a host country can be integrated into his global strategies and the overall quality of the country's enabling environment (Foreign, 2002). Although some factors like market size or location are outside the control of host country's government it has some possibilities to influence the investment decision of a foreign investor through special investment incentives. During 2008 110 new FDI-related measures were

[2] Covers economic, social and political stability; rules regarding entry and operations; standards of the treatment of foreign affiliates; policies on functioning and the structure of markets; tax, trade, environmental, intellectual property rights, competition and privatization policies; International agreements on FDI and political risk.

introduced in the world, of which 85 were more favourable to FDI (World Investment Report, 2009).

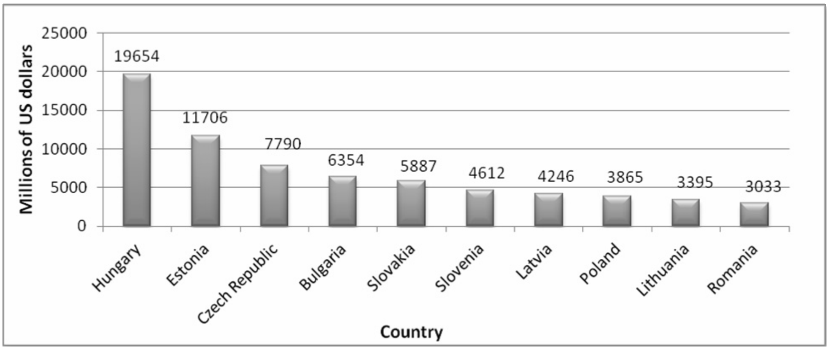
FDI incentives can be defined as "any measurable advantages accorded to specific enterprises or categories of enterprises by (or at the direction of) a government, in order to encourage them to behave in a certain manner" and include "measures…designed either to increase the rate of return of a particular FDI undertaking, or to reduce (or redistribute) its costs or risks" (Tax incentives, 2000). An incentive may encompass a wide range of business activities such as revenues, cost of equity, corporate tax, land, labour, inputs, capital and cost of debt (Survey, 1997). A government can influence the market in three broad ways - through financial interactions, rules and regulations and direct provision of goods and services (Promoting, 2009). Usually governments are oriented towards large long-term investments, innovative and competitive products, modern management and environment friendly manufacturing methods therefore MNE's are more favoured than SMEs (Ögütçü, 2002). Incentives are most important in motor vehicle and transport equipment, professional equipment and electrical equipment industries (World Investment, 2009).

The most popular incentives are regulatory, financial and fiscal incentives. Regulatory incentives which are quite rare cover derogations from national rules and regulations by easing labour-market, environmental and socially related requirements. Financial incentives include government grants, infrastructure or training subsidies, relocation support, equity participation, credits, insurance at preferential rates, depreciation methods etc. They are used by a host country government to correct market failures, to overcome transaction costs, to reap the externalities of foreign presence. Fiscal incentives are direct or indirect subsidies or tax relieves and is the most often used inducement, especially by developing countries as fiscal measures do not require direct payments from scarce public funds. Navaretti and Venables (2004) analysed the tax policies in the host country and came to the conclusion that the level and location of FDI is sensitive to tax incentives. Hansson and Olofsdotter (2010) discovered that fiscal incentives are especially important for NMS where tax size determine whether FDI takes place as well as the amount invested while for the EU15 tax differentials seem to be less important.

Quite often countries establish *special economic zones* (SEZ) to make a country more attractive for FDI. There economic laws are usually more liberal, a business climate is more favourable and a broad set of incentives and benefits is offered. SEZs can cover a broad range of special zones (FIAS, 2008). Free trade zones are duty-free areas where a foreign investor can find warehousing, storage, and distribution facilities for trade, transshipment, and re-export operations. Export processing zones are industrial estates targeting foreign markets. Enterprise zones are used to revive distressed territories through the provision of tax incentives and financial grants. Free ports include larger areas where many types of activities (tourism, retail sales, and permit on-site residence) are accommodated. Specialized zones encompass tourism zones, science/technology/industrial parks, logistics parks, airport-based zones.

Despite that there exists a trade-off between the incentives and FDI, the efficiency of incentives can be strongly questioned, and potentially substantial opportunity costs stressed (Blomström and Kokko, 2003). Competition among governments may overbid and subsidies can surpass the level of spillover benefits. According to Navaretti and Venables (2004), due to diversity and complexity of FDI determinants it is very difficult to determine the quantity of FDI attracted by investment incentives. To know if an investment could have been attracted with fewer incentives it could be useful to compare it with other projects over time. The greatest challenge is to estimate what would have happened without the incentive (Thomas, 2009). Competition for FDI creates a risk that global wars for FDI may cause costly incentives that deteriorate public finances, introduce market distortions and decrease global standards of protection of environment or labour rights (Oman, 1999). In some cases, however, incentives can be justified. In emerging economies where domestic savings are too low to finance economic expansion FDI can become a source of external finance. Governments can also grant incentives if there exists a market failure that hinders foreign companies from earning a normal return on FDI. However, when the number of foreign investors is large a host country assumes that an investor will invest in any case so it can offer low or any incentives (Luski and Rosenboim, 2009).

The incentive systems in new EU countries have varied over time and there exist considerable differences. In the early years of transition some countries such as Hungary and the Czech Republic started introducing tax holidays and other incentives. In the first half of the 1990s most of the countries eliminated or restructured their incentives and reformed their tax systems, however, in the second half of the 1990s a tax competition began (Martinez-Vazquez *et al.*, 2000). During that time the Czech Republic, Hungary, Poland and Slovakia were offering generous tax holidays, free trade zones, training grants, while Baltic States relied on low rates of corporate income tax. As a result of countries' efforts to attract FDI, from 1995 to 2001 the region's FDI stock quadrupled (Cass, 2007). The period since 2001 is characterized by stabilization of incentives and rapidly falling tax rates. This led to the reduction of tax holidays and emphasis on cash grants and stimulated some levelling up in the countries where incentives were lower. In recent years due to the financial and economic crisis dramatic changes in FDI patterns have caused shifts of FDI inflows in almost all countries, f. e. in 2009, the number of projects in Hungary, the Czech Republic and Romania fell by 40% and the attractiveness of CEE in comparison to previous year declined from 42% to 24% (Waking up, 2010).



Source: UNCTAD, 2009a, 2009b.

Figure 1. **Cumulated FDI (1990-2009) per Capita (mln. USD) in NMS**

The leading country in attracting FDI in NMS is Hungary while the lowest level of FDI per capita exists in Lithuania and Romania. One of major determinant of FDI volumes is incentives applied by the governments (see *Figure 1*).

3. Research Methodology

NMS usually compete with each other by granting investment incentives. The main objective of the empirical research was to ascertain the types of investment incentives granted by NMS designed to attract FDI and compare incentive systems used in different countries. Previous studies related to NMS are designed mostly to analyse the patterns and contribution of inward FDI and investment policies during transition period (Hirvensalo, 2000; Bevan and Estrin, 2000). Bitzenis (2003) examines the impact of granted incentives in the NMS that were aimed at supporting the transition into the market economy. He concludes that there is no evidence in view of the type and amount of incentives. Brainard (1997) also finds that tax incentives have little impact on FDI. The problem of these studies is that they are concentrated only on few countries. Another shortage of these studies is that they focus mainly on specific features of transition economies (ex. human factor quality, industrial productivity) rather than on incentives or concentrate only on the impact of taxation on location decisions (Measuring, 2004). In previous studies investment incentives are only one of many factors while our study is concentrated only on investment incentives. No specific period for the analysis is drawn because of different dates when countries introduced or modified their incentive programmes, the study mainly focuses on the latest incentive schemes which existed in NMS in 2010.

The main question of the study was why countries with similar economic environment have different FDI inflows. In such a case the volume of FDI may depend on FDI incentives offered by the host country. In order to reach the objectives mentioned in the previous chapter two hypotheses are tested. The first hypothesis is the following: the volumes of FDI depend on the scope of incentives applied by the host country, the second: financial incentives have a greater impact than fiscal incentives or SEZ on the investor's decision to invest in the host country. The research focuses on FDI incentives in NMS and is based on three step methodology that encompasses the composition of FDI incentive systems in NMS, the perceived attractiveness of FDI incentives, and Lithuania's position in the region.

FDI incentives in NMS are grouped in three main groups (financial, fiscal, SEZ) on the basis of data provided by Investment Promotion Agencies (IPAs) on their official websites or submitted by IPAs especially for this study. Data was collected by authors in 2010 and was confirmed by most IPAs excluding Bulgarian, Romanian and Slovenian agencies. Due to the complexity the incentives were not ranked by their importance indicating only their existence (+) or absence (-) in a particular country.

The survey of FDI incentives attractiveness was done using a questionnaire where foreign owned companies were asked to rank FDI incentives according to their attractiveness for FDI (1 – very attractive, 10 – not attractive). A form of non-probability sampling called the judgment sample was used. It means that selected companies representing various sectors are considered to be most typical and representative among the companies investing in Lithuania. Most companies are MNE's and have business experience not only in Lithuania but also in other NMS. Research is based on the answers of 30 companies. A survey of four experts in FDI promotion that contributed to the creation of investment promotion strategies or represented investors associations was used to identify Lithuania's position in investment promotion among other NMS.

4. Research Results

4.1 Analysis of Administrative Measures

Incentives are usually granted under some special conditions which should be met by investors therefore analysis of incentives starts with overview of regulatory measures applied by NMS. Only main regulatory measures were covered by the research. Incentives granted to foreign investors can differ according to the form FDI is done, green field or mergers and acquisitions.

Table 1 demonstrates that all countries target FDI to the key business activities. The most generous incentives are offered to FDI in R&D and manufacturing. Regional policy channels investment to less developed areas and is applied even in small countries such as the Baltic States. The volume of investment or minimal investment is another common criterion used in all countries indicating a preference for big investments and MNCs. Investment in job creation also is important for all countries. The Czech Republic, Poland, Slovakia, Hungary, Bulgaria and Romania also control the amount of the grant (intensity of the aid) devoted to a foreign investor by setting a ceiling for a subsidy. FDI in environmental development are supported only by few countries.

Table 1. Regulatory measures in NMS

Regulatory measures	**CZ**	**EE**	**LV**	**PL**	**LT**	**SL**	**SK**	**HU**	**RO**	**BU**
Key business activities	+	+	+	+	+	+	+	+	+	+
Investment volume	+	+	+	+	+	+	+	+	+	+
Job creation	+	+	+	+	+	+	+	+	+	+
Financing of certain expenses	+		+	+	+	+	+	+	+	
Export-orientation	+		+		+	+			+	
Environment development	+					+	+	+	+	
Minimal length of project	+			+		+	+		+	+
Aid intensity	+			+		+	+	+	+	+
Regional policy	+	+	+	+	+	+	+	+	+	+

Source: authors' own interpretation.

4.2 Analysis of Financial Incentives

Financial incentives usually are used by industrialized countries to attract MNEs. Nowadays these incentives are more popular than traditional tax relieves. *Table 2* presents the findings of IPA survey on FDI incentives packages in NMS.

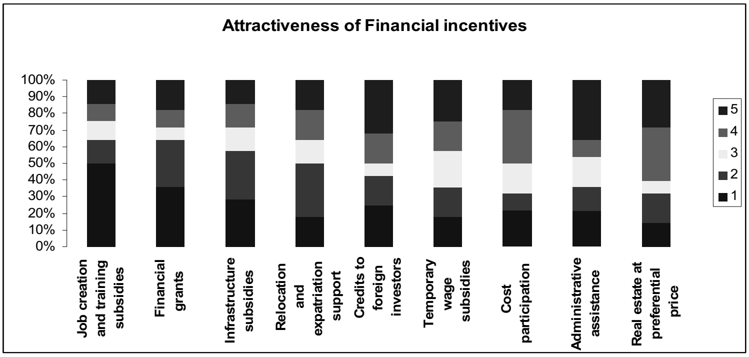
Table 2. Financial incentives in NMS

Financial Incentives	**CZ**	**EE**	**LV**	**PL**	**LT**	**SL**	**SK**	**HU**	**RO**	**BU**
Financial grants	+		+	+	+	+	+	+	+	+
Infrastructure subsidies	+	+	+	+	+				+	+
Job creation and training subsidies	+	+	+	+	+	+	+	+	+	+
Administrative assistance	+		+	+				+		+
Temporary wage subsidies	+	+	+		+					+
Credits to foreign investors		+	+	+	+					
Real estate at preferential price	+		+	+			+			+
Cost participation						+			+	

Source: authors' own interpretation.

The most frequently used type of financial incentives is subsidies related to job creation and training. Bulgaria, Estonia, the Czech Republic and Lithuania also offer temporary wage subsidies. Another commonly used incentive is financial grants offered for acquisition of tangible and intangible assets**.** In Lithuania they are used to subsidize construction, equipment and salary costs. In Hungary large entities can be entitled to receive state subsidies up to 50% of the eligible costs for manufacturing, logistics, R&D, shared service centre, tourism projects. Less popular type of incentives is provision of administrative assistance, i.e. Latvia provides start-up assistance which includes location, establishment and local networking guidance and preferential work and residence permit formalities for the key company personnel. Latvia and Czech Republic offer real estate at preferential price. For investments into tourism sector foreign investors in Romania may apply for project implementation stages which are called cost participation. In Poland foreign companies investing in R&D sector can apply for credits to purchase and development of new technologies.

The findings based on IPAs data were compared to the results of the second survey where foreign companies were questioned about attractiveness of different types of financial incentives (see *Figure 2*). Foreign investors give priority to job creation and training subsidies, financial grants and infrastructure subsidies.



Source: authors' own interpretation after UNCTAD, 2009a, 2009b.

Figure 2. **Attractiveness of Financial Incentives (1 - Very Attractive, 5 - Not Attractive)**

Both surveys showed that financial incentives related to labour force are the most popular and attractive type of FDI incentives. Only Romania is giving a priority to environmental protection projects and programmes whereas other countries are mostly oriented to R&D activities or shared service centers (Waking up, 2010). Before the accession to the EU the Baltic States relied mainly on low corporate tax rates or SEZ while current research revealed that in the meantime financial incentives are also widely used.

4.3 Analysis of Fiscal Incentives

In area of taxation a variety of policy instruments include direct (income, corporate taxes) and indirect (consumption and transaction taxes) fiscal measures (Foreign Direct, 2010)**.** Fiscal incentives might be a successful tool for attracting MNCs, but can create some problems such as government expenditures, the lack of transparency, market distortions.

Table 3 summarizes the findings based on IPAs' data. The fiscal incentives are divided into four broad groups: reduced direct corporate taxation, incentives for capital formation, removal of obstacles for cross-border operation and other fiscal reduction. Most authors agrees that fiscal incentives and especially temporary relief from corporate income tax is one of the most popular FDI incentives in less developed countries and NMS during transitional period.

Table 3. Fiscal incentives in NMS

Fiscal FDI Incentives	CZ	EE	LV	PL	LT	SL	SK	HU	O	U
Reduced direct corporate taxation										
Reduced rates of corporate income tax			+			+	+	+		
Tax exemptions	+		+	+	+		+	+		
Flat tax rates		+	+	+						
Tax holidays	+		+	+	+	+		+		
Incentives for capital formation										
Investment allowances			+	+	+	+		+		
Investment tax credits										
Deductions on reinvested profits		+								
Removal of obstacles for cross-border operation										
Withholding tax			+	+		+				
Taxation of employees		+	+			+	+			
Other fiscal reductions			+	+		+				

Source: authors' own interpretation.

In NMS tax relieves can take many forms and variations, i.e. Slovenia offers a deduction from the tax base of 20% on investment in R&D and it may be increased to 30-40% depending on the regional relief scheme. Depending on the sector the Hungarian government until 2011 offered tax exemptions for 80% of the corporate tax payable for 10 years. Flat tax rates exist in Latvia, Estonia and Poland. For R&D investments Hungary may offer additional incentives such as tax benefits on credit agreements, tax free development reserve for four years, tax free employment of students. In Lithuania, foreign companies can apply for triple deduction in R&D investments. In Bulgaria where most of incentives are related to labour force foreign investors can apply for tax deductions for employment. Bulgaria also offers corporate tax exemptions for manufacturing companies investing in regions with high unemployment rate. The latest tax rebate in Latvia affects new technological equipment for manufacturing utilized in commercial activity. Foreign investors starting business in Romania's regions with special status (32 zones where unemployment is three times higher than the country's average) can get reduction from corporate tax as long as the region retains its status. On the contrary, in the Czech Republic new companies established for the investment project are eligible for corporate tax relief for up to five years while an expansion project with an existing Czech company can apply only for partial tax relief. Nowadays in Poland tax exemption from the real estate tax (lands, buildings) is the most important.

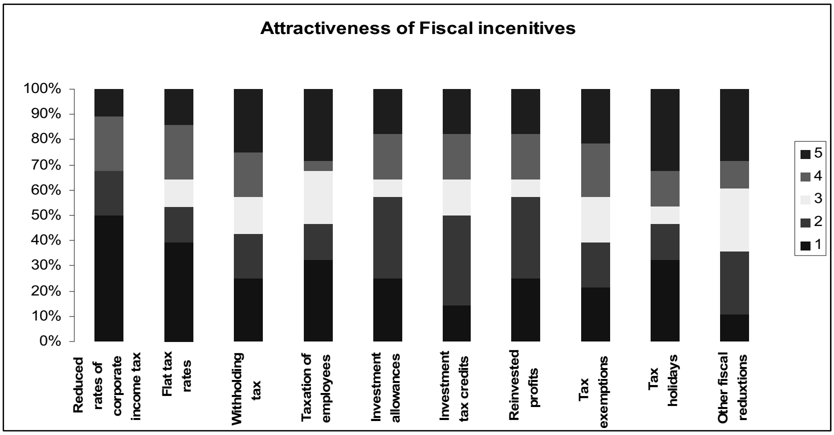
There can be two types of incentives for capital formation in form of investment allowances earned as a fixed percentage of qualifying investment expenditures: accelerated depreciation or enhanced deductions. This tax incentive is applied in Latvia, Poland, Slovenia, Romania, Lithuania, Hungary and Bulgaria. In Slovenia depreciation allowance on building and equipment is quite favourable, Hungary offers special tax allowances for SME while

Lithuania applies super-accelerated depreciation for foreign companies operating in a R&D sector. Romania applies accelerated depreciation method (50% for the first year) for bigger investments, while in Latvia accelerated depreciation is related to purchase of new equipment used for manufacturing or commercial activities. In Estonia and Poland this type of tax incentive was used until 2007. Although Estonia is one of few countries where tax relief is not offered, it applies 0 % tariff for reinvested profit. Tax credits are not applied widely.

Removal of obstacles for cross-border operation is also not of the least importance in NMS. A withholding tax on investor's income in Slovenia is not paid if was paid in host country. In Bulgaria dividends, distributed by a subsidiary, usually are not subject to a withholding tax. Investors can get the same incentive in Latvia where capital gains, incomes from real property are held less than 12 months.

Some other types of fiscal reductions can be offered in NMS. As an alternative to a normal corporate income tax Slovenia and Latvia also created tonnage taxes regime that is available for shipping companies in respect to their income from the operation of ships in international traffic. Furthermore, a taxpayer may also carry forward the loss incurred in one accounting period by reducing the tax base for the following seven years. Bulgaria also offers a special preferential VAT regime for imports of goods necessary for the implementation of an investment project and for the tourism sector. In most countries municipalities may also offer different forms of incentives, which are negotiated on a case-by-case basis.

The results of the research based on IPA's data can be compared with the results of the survey of MNCs (see *Figure 3*).



Source: UNCTAD, 2009a, 2009b.

Figure 3. **Attractiveness of Fiscal Incentives in NMS (1 - Very Attractive, 5 - Not Attractive)**

Figure 3 demonstrates that reduced rates of corporate tax are the most attractive incentive among respondents from MNCs. The same might be said about flat tax rates which are attractive for foreign investors although are rare applied. Tax exemptions and tax holidays are quite often applied by the governments but are less preferred by the MNCs. The reason is that tax exemption may be of little benefit if an investor is not making profits. Important incentives for foreign investors are withholding tax and taxation of employees.

4.4 Analysis of SEZ

SEZ in NMS very often rely on the re-use of existing infrastructure and facilities in addition to „greenfield" development (FIAS, 2008). Polish SEZs cover parts of existing towns and specialized facilities while Klaipeda zone in Lithuania is the conversion of a former Soviet air force base. Slovenia is the only country that uses a traditional export processing zone oriented towards manufacturing and exports while Bulgaria, Hungary, Latvia, Lithuania, Poland apply a hybrid model. SEZ where mostly trade-related activities are supported are prevalent in the Czech Republic, Estonia, Latvia, Romania and the Slovak Republic. Free economic zones can be found in Poland, Lithuania and Latvia while other countries more often use free trade zones. In Poland foreign investors can find industrial and technology parks that can be considered natural extension of SEZ. Polish SEZs offer attractive tax exemptions, employment incentives and well-prepared investment lots. In Lithuania's two free economic zones the following tax incentives are offered - 0% of profit tax in the first 6 years and 50% reduction of profit tax value in the next 10 years; no tax on dividends or real estate tax is charged. In addition, Lithuania also has 10 science and technology parks that offer favourable infrastructure. Now 5 integrated science, studies and business centers (valleys) are being developed. Latvia possesses four separate SEZ (three ports and one inland) where corporate tax discounts (up to 80%) as well as 0% rates for VAT, customs and excise duties are offered. The Czech Republic also exempts from customs duties or VAT if material, components and semi-finished products are exported into free trade zone or used in processing of final product. Though in Czech Republic exist only few industrial parks or zones they played an important role in attracting FDI. Romania has 6 free trade zones offering privileges such as exceptions from customs and import/export taxes, personnel income taxes or guarantees that the transfer of capital and profit will not be restricted after the investment is terminated. Estonia offers only free zones where customs and excise duties are not applicable. Hungary offers a diverse range of industrial parks where investors can get support from municipalities, well developed infrastructure and extensive services. In these parks more than half of largest MNEs investing in Hungary are located. In the Czech Republic and Hungary FDI helped to establish new progressive industries while in Lithuania majority of FDI were made in traditional medium or low technology industries (Miškinis and Lukaševičiūtė, 2009).

A survey of foreign companies indicated that the most preferable SEZ were enterprise zones and special zones such as industrial or technological parks. Export processing zones are seldom used therefore foreign investors did not assess their attractiveness highly. Free ports received the lowest rank and are attractive only for a very specialized foreign investor.

5. Assessment of FDI Incentives in Lithuania

Among investors Lithuania is criticized for its ineffective incentive system and poor attention to FDI. We carried out the assessment of FDI incentives in Lithuania on the basis of interviews with four Lithuanian experts representing different interest groups. All experts were asked to define the main drawbacks of Lithuania in terms of FDI incentives. Experts listed the following advantages of Lithuania: the biggest market in the Baltics, skilled labour, a bridge between East and West markets, life quality. The main drawbacks of Lithuania include lack of incentives, bureaucracy, low level of knowledge/innovation economy, poor image, the inefficiency of Lithuanian Development Agency. Two of four experts stated that conditions and incentives for foreign investors are not clearly defined excluding support for R&D project (triple deduction and super-accelerated depreciation). Another Lithuania's restraint for foreign investors is small size of a country and SEZ. Two of four experts agreed that though several investment promotion strategies were developed their poor implementation didn't have real effect on FDI inflows. The government didn't pay much attention to investment promotion until recent economic crises. When those banks seized their easy credits only two options for Lithuania remained: FDI or venture capital funds. While venture capital funds were too difficult to attract FDI appeared as real and quickly accessible source of financing. The Lithuanian government understood that without an attractive package of investment incentives it is very difficult to attract FDI.

Conclusions

During transition period FDI promotion policies have been of secondary importance in all Baltic countries – in contrast to other NMS such as the Czech Republic and Hungary. Other countries such as Poland and Hungary started attracting foreign companies earlier than the Baltic ones.

Financial incentives in NMS are used not only to attract FDI but also to solve employment problems or encourage the development of specific sectors/industries. In every country the volume and range of financial grants have different variations and different solutions are used to deal with the same market failure. Job creation subsidies and financial grants are the most popular financial measures while administrative subsidies and real estate at preferential price are rarely used and poorly appreciated by investors.

Almost all countries offer different kinds of tax relieves which are made available for foreign companies in country's key business sectors, less developed regions or stimulating employment. The most popular fiscal incentives used in NMS are related to reduced direct corporate taxation. There exist a discrepancy in rendering importance to certain incentives by foreign investors and governments.

SEZ in NMS are especially effective in job generation, besides contribute to export development and inflows of FDI. Furthermore, governments maintain these zones not only during transition period but also in their modern investment promotion strategies.

Research did not identify any strong linkage between cumulative FDI per capita with the number of FDI incentives. It means that just a big number of FDI incentives introduced in a host country cannot automatically guarantee FDI inflows but only their effective combinations and specialization can lead to the increased FDI. Consequently there are no good or bad policies, successful FDI promotion being a matter of matching the country's FDI policies to specific circumstances of the economy.

A comparison of average ranks of FDI incentives' attractiveness provided a proof that companies participating in the survey consider financial subsidies to be more attractive than other FDI promotion tools.

Lithuania experts' survey revealed that the loss in the regional competition for FDI is related to doubtfully defined and poorly implemented FDI incentive system in Lithuania. Experts consider that granted financial incentives and proactive government's activities that were started in the presence of current crisis had a great impact on decision of MNC to invest in the country.

To test the first hypothesis that the volume of FDI depends on the scope of incentives applied in the host country cumulated FDI (1990-2009) per capita were compared to the scope of FDI incentives in a country. No strong relation between these two variables was found indicating that the first hypothesis was not confirmed. This means that just an increase in number of FDI incentives does not guarantee automatic FDI inflows. However, the research has some limitations – different types of incentives cannot be treated equally and have different effects on FDI amounts. Estonia offers fewer incentives but is a leader in the region in FDI per capita. FDI incentives should be used not only to increase FDI inflow but also to retain higher levels of value-adding FDI and maximize positive externalities. Thus a country should not try to introduce as much incentives as possible but concentrate on their effectiveness.

The second hypothesis that financial incentives have a greater impact than fiscal incentives or SEZ on an investor's decision to invest in the host country was tested with the survey of foreign companies about attractiveness of different types of incentives. It was confirmed that companies consider financial subsidies to be more attractive than other FDI promotion tools.

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PALYGINAMOJI TIESIOGINIŲ UŽSIENIO INVESTICIJŲ PASKATŲ NAUDOJAMU NAUJOSIOSE EUROPOS SĄJUGOS ŠALYSE ANALIZĖ

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SANTRAUKA

Straipsnyje atliekama paskatų, naudojamų naujosiose ES šalyse siekiant pritraukti į šalį tiesiogines užsienio investicijas, palyginamoji analizė. Tyrimą sudaro trijų žingsnių metodologija, kurioje: a) bendradarbiaujant su investicijų rėmimo agentūromis analizuojama TUI paskatų struktūra naujosiose ES šalyse; b) atlikus užsienio kapitalo įmonių apklausą Lietuvoje įvertinamas investuotojų požiūris į TUI paskatų patrauklumą; c) remiantis keturių Lietuvos ekspertų apklausa įvertinama TUI situacija Lietuvoje. Tyrimo rezultate prieita išvados, kad nėra tiesioginio ryšio tarp šalies vyriausybės siūlomo paskatų skaičiaus ir TUI apimčių. Tai reiškia, kad didelis paskatų kiekis automatiškai negarantuoti ir didelių TUI įplaukų. Tyrimo metu taip pat buvo atskleista, kad finansinės paskatos turi didesnį poveikį investuotojui nei fiskalinės paskatos ar specialios ekonominės zonos. Lietuvos ekspertų apklausa parodė, kad Lietuva regioninę konkurenciją dėl TUI pralaimi dėl prastos paskatų sistemos ir kad naujos vyriausybės iniciatyvos taikant finansines paskatas paskatino naujų tarptautinių bendrovių atėjimas į Lietuvą.

REIKŠMINIAI ŽODŽIAI: tiesioginės užsienio investicijos, finansinės ir fiskalinės paskatos, specialios ekonominės zonos, Europos Sąjunga.