Attracting FDI to transition countries: the use of incentives and promotion agencies

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Transition countries have made extensive use of two policy measures that aim to encourage foreign direct investment, namely fiscal and financial incentives and Investment Promotion Agencies (IPAs). Drawing on data in respect of 27 countries and using specially constructed scales, activity levels over time for these two measures are evaluated; countries are compared; trends are identified; and the factors behind policies are discussed. The data suggest that use of incentives increased from the mid-1990s but that recent falls in tax rates and, in some countries, accession to the EU are reversing this trend. Incentives do not appear to have been used as a way of compensating for disadvantages in the business environment during the earlier stages of transition; their later importance in some countries may have been influenced by active participation in international competition for export-oriented investment. The use of IPAs seems linked to progress in transition.

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1. Introduction

Throughout the world, governments have been seeking to attract foreign direct investment (FDI) through a variety of measures, including the use of financial and tax incentives and the establishment of Investment Promotion Agencies (IPAs).

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Both of these measures are extensively employed: while precise data on the supply of investment incentives are limited (Oman, 2000, pp. 7 and 114), it is clear that most countries offer them (UNCTAD, 2000, p. 11), and “nearly every country” has an IPA (Morisset and Andrews-Johnson, 2004, p. 8). This article examines the use of these measures by transition countries, with the aim of answering some basic questions: to what extent have countries used them relative to each other and over time; what types of incentives have countries offered; and can policies in relation to incentives and IPAs be explained in terms of the stages that countries have reached in the transition process or by other factors?

On first inspection, this may seem well-covered territory, at least so far as investment incentives are concerned. Data on the tax rates and incentives packages of individual countries can be readily obtained from a variety of sources, including international accounting firms. Scholars have examined the evolution of tax systems during transition, seeking to identify common themes (Martinez-Vazquez and McNab, 2000; Mitra and Stern, 2002; Gandullia, 2004). There is a range of studies that present and compare tax policies related to investment, drawing on data from various transition countries (Hunya, 2000; Mah and Tamulatis, 2000; Antaloczy and Sass, 2001; Sedmihradsky and Klazar, 2002; OECD, 2003; Meyer and Jensen, 2004). There is also a growing body of work that examines the effectiveness of tax and incentive policies in attracting FDI (Sedmihradsky and Klazar, 2002; Beyer, 2002; Mallya *et al.*, 2004). All of these studies have been valuable sources for the present study, which, however, has different goals. It attempts to measure the intensity of incentives systematically, in order to enable comparisons over time and across countries; it does this by applying a specially constructed scale to the incentive packages offered by 27 transition countries. This procedure undoubtedly involves simplification and a degree of subjectivity, but it brings important advantages in terms of insight into overall trends and the ability to assess the relative position of individual countries.

Data on the scale and scope of investment promotion[1] activities in transition countries are limited. Comparative assessments of IPA practice in transition countries are virtually non-existent. An UNCTAD study (UNCTAD, 2001) of IPAs worldwide included aggregated data on 15 agencies in Central and Eastern Europe; individual country data were not reported. While a number of studies deal with the effectiveness of IPAs (such as Wells and Wint, 2000; Wint and Williams, 2002; Morisset, 2003; Morisset and Andrews-Johnson, 2004; Charlton and Davis, 2004), few use data from transition countries and all present only aggregate findings. In the present study, the IPA activities of 27 transition countries are assessed individually and an attempt is made to measure the intensity of these activities so that, as with incentives, comparisons can be made and trends identified.

The information assembled on incentives and IPAs provides a basis for consideration of the drivers of country policies in these fields. Have incentives been used to overcome investor reluctance to invest in newly liberalized economies and were they therefore most likely to occur in the early stages of transition? Have they been a means of offsetting high tax rates, and are they likely to be reduced if overall tax rates fall? Have they been driven by competition for export-oriented, efficiency-seeking investment? Have IPAs grown out of a need to attract initially reluctant investors or have they become more prevalent and more active as countries make progress towards a market economy?

The article begins by considering the rationale for interventions by transition countries in these two areas and

[1] While some writers apply the term “investment promotion” to investment incentives (e.g. Hanson, 2001) and others situate incentives among the tools of investment promotion (e.g. Head *et al.* 1999, p. 204, Charlton and Davis, 2004, p. 3), the majority distinguish incentives from promotion, and use “investment promotion” to describe the activities of IPAs (e.g. Wells and Wint, 2000; Loewendahl, 2001; Morisset and Andrews-Johnson, 2004); this article follows the latter usage.

formulating hypotheses as to the factors that shape their evolution. The data collection exercise is described and trends in incentives and promotional activities are analysed. The hypotheses about the factors shaping incentive and promotion policy are assessed. Finally, conclusions are drawn.

2. Rationale for incentives during transition

FDI incentives have been 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". They are seen as distinct from "broader non-discriminatory policies" such as "the general…fiscal regime for business operations" (UNCTAD, 2000, p. 11). This article takes a less precise view of the boundaries between FDI incentives and the rest of the tax system. Its scope includes investment incentives that are available to local as well as foreign investors; in practice, such incentives are often used as a tool to attract FDI and are principally taken up by foreign investors. The borderline between general fiscal rules and specific incentives is not always clear and there can be an interaction between them: for example, between tax holidays and rules about the carrying forward of losses. Therefore, while accepting that a key characteristic of incentives is that they are selective in their application (OECD, 2003, p. 67), it is assumed that they may be broadly targeted and that they should be considered "alongside basic features of the tax system" (OECD, 2003, p. 39).

The term "FDI incentives" covers fiscal and financial benefits. Fiscal incentives include full or partial holidays from tax; reductions in the standard rate of tax; tax reductions conditional on reinvestment of profits; investment allowances and investment tax credits; accelerated depreciation of assets; preferential treatment of profit on exports; tax deductions based on specific types of expenditure (e.g. R&D); and exemptions from import duties on capital goods or other inputs (list adapted from UNCTAD, 2000, p. 20). Financial incentives include: cash grants related to the value of assets invested or numbers employed or training costs; provision of subsidized facilities such as factories or sites; provision of infrastructure related to new facilities, such as roads and links to utilities; and direct subsidies. Entitlement to incentives can be based on criteria such as: scale of investment; numbers employed; export orientation; or sector/industry. "Export Processing Zones" (EPZs), "Special Economic Zones" (SEZs) or "Free Trade Zones" (FTZs) generally combine some of the above incentives – for example, exemptions from import duties, tax holidays and low cost facilities – with a streamlined administrative system that is distinct from that of the rest of the country.

In the context of transition, where ownership of productive assets is undergoing substantial change and private capital is scarce, the rationale for encouraging foreign investment has tended to focus on the contribution of FDI to the transition process. The possible contributions of FDI to transition include "solv(ing) the restructuring problems (of state enterprises) by passing them on to foreign firms" (Lavigne, 1999, p. 171); "restructuring and improving the technological structure of exports" (Smith, 2000, p. 182); compensating for the inadequacy of domestic financial markets (Gros and Steinherr, 1995, p. 289); and contributing to the upgrading of skills, knowledge and managerial expertise (World Bank, 2002, p. 67). The interaction between FDI and the dynamics of the transition process suggests that incentives might be particularly necessary in the early stages. Even with rapid liberalization and macroeconomic stabilization, time would be needed to create a legal, institutional and administrative framework that would be attractive to international business. In the meantime, investors could face levels of cost, uncertainty and risk that were outside their normal decision criteria, or higher than in their home countries or in alternative investment locations. They might also take longer to bring their investments to full production. This imbalance between urgently needed economic benefits on the one hand and returns to investors on the other might seem to fit the classic "market failure" rationale for incentives. A number of broader arguments in support of incentives could also be seen as especially relevant to transition countries: firstly, transformational developments may need to be insulated from the hindrances of the wider environment – for example, EPZs may overcome administrative deficiencies by creating an enclave with simplified and relatively efficient procedures (Levy, 1990, p. 27); secondly, incentives can have a "signalling effect", communicating a government's commitment to stimulate FDI (Morisset and Pirnia, 2000, p. 13); and finally, assuming a tendency for some export-oriented investment to "cluster", incentives can attract a "first mover investor who is …followed by competitors or suppliers" (UNCTAD, 2002, p. 204). All of these considerations were most clearly visible in the earlier stages of the transition process. It might be expected that their relevance would diminish as the transition process advanced and the business environment matured, and that incentives would therefore become less necessary over time. This perspective of the role of incentives is referred to here as the "transitional hypothesis".

The development of the tax system provides another possible rationale for the role of FDI incentives in a transition context. When transition began, taxes on companies represented a higher share of government revenue and of GDP than in the high income OECD countries (Mitra and Stern, 2002, pp. 9-10), linked to a tradition of heavy taxation of enterprises. In the early years of transition, countries faced erosion of tax revenues and needed to create institutions for raising revenue in a market economy. Incentives could arguably insulate potential investors both from the initial high tax rates and from the uncertainties associated with tax reform. Thus a "tax hypothesis" would link the level of incentives to the state of tax reform and to the corporate tax rate; in part, it is a subset of the "transitional hypothesis".

An alternative interpretation derives from the investment-development path, outlined by Dunning and Narula, which suggests that as an economy moves from dependence on primary industries, through the expansion of manufacturing, to the rise of the services sector, the level and composition of FDI also evolves from resource-seeking in the early stages to a combination of efficiency-seeking, market-seeking and "asset-augmenting" in the later stages (Narula and Dunning, 1998, p. 34). Radosevic *et al.* adapted this to relate changes in the types of FDI to the specific circumstances of transition; in their model, FDI moves from predominantly market-seeking to predominantly efficiency-seeking (i.e. export-oriented) (Radosevic *et al.*, 2003, p. 65). Given that export-oriented FDI is more likely than other forms of FDI to be influenced by incentive levels (Morisset and Pirnia, 2000, p. 9), there is the possibility that, far from diminishing as transition progresses, incentives will be driven up by competitive pressure when the emphasis shifts to efficiency-seeking investment. This will be referred to as the "competitive hypothesis".

3. Rationale for Investment Promotion Agencies during transition

In their pioneering work, first published in 1990, Wells and Wint defined investment promotion in terms of "promotional techniques", which comprise "providing information to potential investors, creating an attractive image of the country as place to invest, and providing services to prospective investors" (Wells and Wint, 2000, p. 1). Typically, these are implemented by a single agency – an IPA – but some promotional techniques may be carried on in other ways (e.g. by economics ministries or by embassies) and some IPAs may have other functions (e.g. export promotion). In this article, the term "promotional activities" covers the three key areas defined by Wells and Wint - these will also be referred to as the "classical IPA tasks". Only the activities of IPAs are considered. A fourth task undertaken by IPAs will also be discussed, namely "policy advocacy" – a role identified by Wells and Wint in the light of experience subsequent to their 1990 paper (Wells and Wint, 2000, p. vii). These tasks are explained in table 1, in terms adapted from Morisset and Andrews-Johnson (2004, p. 7).

The economic rationale for promotional activities has much in common with that for incentives. Market failure may

Table 1. Functions of investment promotion agencies

	Function	Description	Example of means
"Classical" IPA tasks	Investor facilitation and investor services	Assisting an investor to analyse his decision, establish a business and ensure it continues to operate.	*Provision of information, assistance in getting approvals, assistance with sites, utilities etc.*
	Image building	Creating the perception of a country as an attractive site.	*Advertising and public relations.*
	Investment generation	Targeting specific sectors and companies in order to create investment leads.	*Identification of targets, direct contact, forums, seminars etc.*
Policy-related activities	Policy advocacy	Supporting initiatives to improve the investment climate and identifying private sector views.	*Surveys, participation in task forces, policy proposals, lobbying.*

Source: author's adaptation from Morisset and Andrews-Johnson (2004, p7).

arise if potential investors are unaware of a location's advantages or have an incorrect impression of its business environment (Morisset and Andrews-Johnson, 2004, p. 10). Loewendahl (2001, p. 2) quotes an IFC assessment that "most companies consider only a small range of potential investment locations; many other countries are not even on their map" (IFC, 1997, p. 49). This is consistent with the literature on strategic decision-making: typically, decision makers face "cognitive limits", "satisfice instead of optimise" and "rarely engage in comprehensive search" (Eisenhardt and Zbaracki, 1992, p. 22). Even if aware of a potential location, companies may fail to assess it because of unfamiliarity or search costs.

As noted earlier, incentives might be justified in the early stages of transition on the grounds that they insulate from or offset disadvantages in the environment, signal that the country is open for business and attract first movers in the formation of export-oriented clusters. Some linked or analogous roles for investment promotion can be envisaged, for example, in assisting potential investors navigate through regulatory processes that are still undergoing reform, creating international awareness that conditions are changing, and alerting investors to the emerging opportunities, including the existence of incentives. Thus, a "transitional hypothesis" might also be used to explain the evolution of IPA activities.

However, the ability of promotional activities to generate investment is likely to be constrained by fundamental conditions related to markets, resources, costs and the general business environment. Promotional activities will be wasted if these conditions are not satisfactory. An investor may be persuaded to consider a location, but if he finds that his needs will not be met or that the financial returns will be inadequate or uncertain, he will not proceed with the project. An alternative hypothesis, labelled here as the "marketing hypothesis" would relate promotional activity to the quality and attractiveness of the investment location being promoted. An IPA might evolve in stages, initially confined to facilitation services and a modest level of image building, and later, when the business environment strengthens, developing into more advanced levels of service provision and the sophisticated targeting of potential investors. Other advantages such as low tax rates, incentives, or proximity to markets or sources of investment might provide additional platforms for promotion.

Policy advocacy – activity related to improving the investment climate - seems conceptually distinct from the "classical" IPA tasks of attracting investment through information and promotional techniques and it is not immediately obvious that it needs to be undertaken by IPAs. The role may emerge because an agency's interactions with investors alert it to their concerns. But it may also reflect the logic of the model of investment promotion, set out by Wells and Wint, in which an IPA's activities are viewed as analogous to industrial marketing, with potential investors as "customers" and the country as a "product" to be marketed (Wells and Wint, 2000, p. 28). This conceptualization of investment promotion as a business process seems to have been formulated primarily as a way of illuminating an IPA's promotional techniques, which are seen as very similar to those of industrial marketing. But, just as marketing is linked to the characteristics of the product being marketed and to the strategy that shapes the overall business approach, by analogy investment promotion can be conceived as closely connected with processes such as the determination of sectoral priorities, the enhancement of the country's capability to attract the desired investment, the choice of incentives to be offered, and the use of those incentives to influence specific decisions. Arguably, these are not all capable of being handled by a single agency, but it is significant that through policy advocacy, many agencies are already seeking to influence the attributes of the "product" (i.e. the business environment) and that some successful agencies go beyond the three classical IPA tasks. Notable international examples are: Singapore's Economic Development Board, which formulates policy (UNCTAD, 2002, p. 222), develops industrial estates (ibid.) and initiates industry clusters (te Velde, 2001, p. 46); and Ireland's IDA, which has considerable discretion in operating a system of incentives (Ruane, 2003, p. 6) and uses its relationships with investors "to promote the development of clusters and agglomerations" (Ruane, 2003, p. 7). The extent to which transition country IPAs have developed along this "policy axis" - from policy advocacy towards development management - will be briefly assessed later.

4. Survey of country practices

This section describes the information collected on country incentives and IPAs and indicates how values have been assigned to them. The first step was to establish the position at the time the data were collected in mid-2005. The incentives offered and the promotional activities undertaken were translated into values on appropriate scales. These "point in time" values were used in combination with other information to estimate values in the period 1994-2003.

4.1 Previous studies and surveys

Studies have described incentives in transition countries in varying degrees of detail, some in the context of a specific focus on tax or incentives, most within wider frameworks such as FDI policies, competitiveness or compliance with WTO requirements. An OECD study (OECD, 2003) describes the incentives available in eight countries in South-East Europe, as part of a report on tax policies relevant to investment in the region, and reviews ten other transition countries for comparative purposes; this has been a valuable source of information on key developments. Other studies include those by Hunya (2000), Mah and Tamulaitis (2000), Antalóczy and Sass (2001), and Meyer and Jensen (2004). Sedmihradsky and Klazar (2002) outline the evolution of tax incentives in the Visegrad countries, examine Czech practice in detail and review evidence on the effectiveness of incentives. Studies of the reform of tax systems in transition countries, such as those by Mitra and Stern (2002), Gandullia (2004), Martinez-Vazquez and McNab (2000) and Appel (2003), deal, *inter alia*, with incentives, providing comparative information and identifying common themes. There is therefore an extensive literature that presents incentive policies in some transition countries, albeit at different points in time, with different levels of country coverage and having different purposes. However, the data are not comparable and, though detailed, are not readily usable for analytical work.

Comparative assessments of IPA practice in transition countries have not been identified. An UNCTAD study (UNCTAD, 2001) of 101 IPAs segmented its findings by region and presented aggregated data on 15 agencies in Central and Eastern Europe, covering activities, resources, priorities, issues and organization. Morisset and Andrews-Johnson included nine transition countries in their survey of the effectiveness of IPAs (Morisset and Andrews-Johnson, 2004) but reported only aggregate findings. In neither case were individual country data reported.

4.2 Incentives: data, sources and evaluation method

For each transition country, the corporate tax rate as of May/June 2005 was identified and the principal incentives offered were noted. The main sources were tax surveys produced by two accounting firms, Ernst and Young (Ernst and Young, 2005) and Price Waterhouse Coopers (PriceWaterhouseCoopers, 2005a) and the websites of the country IPAs. Other sources included other accounting firms or, in the case of some CIS countries, websites of the United States Department of Commerce. The data headings are described in table 2 and the results are summarized in appendix 1.

Table 2. Data on tax and incentives

Heading	*Background*
Company taxation rate %	The top rate of tax applied to the taxable profit of companies.
Tax holidays	Full or partial reduction of profit tax for a defined period.
Tax credits	Reductions in taxable profit, by: amounts related to total investment; accelerated depreciation of fixed assets; employment costs; research and development costs; or other factors.
Grants	Cash grants, based, for example, on number of new jobs created or to reimburse training costs.
Subsidized locations	Subsidized access to premises or sites, e.g. in industrial parks; assistance with cost of infrastructure.
Free trade zones	Areas in which there is a special regime for import duties, sales taxes and profit taxes and which may also be exempt from other rules and requirements; generally related to production for export.

Source: author's analysis.

Certain other incentives were excluded, notably exemptions from import duties and/or VAT on capital goods and other inputs. The rationale for exclusion is the difficulty of evaluating their significance, in a context where import duties have been falling and where VAT on inputs is often recoverable through the operation of the tax system. In some countries, transitional arrangements for existing investors have been instituted when incentives have changed. The data in appendix 1 are based on incentives applicable to new investors.

The incentives offered by each country were assessed and a score was attributed to them. Determining the value and attractiveness of incentives to potential investors is difficult. In principle, they should be considered in conjunction with the tax system as a whole, leading to computation of an "effective tax rate" for FDI projects in each country. In their study of the impact of incentives on location decisions in the EU, Hubert and Pain calculated this as "the ratio of cash receipts from taxes and profits of corporations to the total operating surplus", on the assumption that "this rate, which reflects the past profitability of all firms in the host country, corresponds to the one that might be faced by the representative foreign firm in that location in the future" (Hubert and Pain, 2002, p. 345). However, this assumption would probably not be valid in transition countries, where incentives and tax systems have been changing rapidly and the past may not be a good guide to the future. In principle, a more relevant measure should result from computation of a forward looking rate, based on expected cash flows before and after tax from a hypothetical investment project. The methodology has been extensively used by the EU in computing effective tax rates for member countries (e.g. European Commission, 2001a). An EU Working Paper by Finkenzeller and Spengel examines effective tax rates in the countries that joined the Community in 2004, and incorporates the effects of the tax incentive considered to be most typical of the each country concerned (Finkenzeller and Spengel, 2004, p. 40). However, the results have not been used here, due to the limited number of transition countries covered, the somewhat arbitrary approach to the incorporation of incentives, and the difficulty attached to including significant incentives such as FTZs.

The home country's tax environment may also affect the benefit derived from incentives, although this is a contested area. Morisset and Pirnia quote research suggesting that "tax incentives are more effective when they apply to firms from countries whose governments do not tax their foreign activities" (Morisset and Pirnia, 2000, p. 17), the logic being that if foreign income is taxed in the home country, the tax saved abroad could be recaptured by more tax paid at home. However, it has been argued that "with intelligent tax planning it ought not to be too difficult to avoid having the benefit of host country incentives neutralised by the home country" (OECD, 2003, p. 87) and this is the assumption made here.

In the absence of viable alternatives covering all of the countries under review, a simplified and judgement-based approach was adopted for this study. The level of incentives was assessed using a four point scale analogous to that used by the EBRD in its transition indicators. A score was assigned to the attractiveness of the total incentives offered by each country in May/June 2005 on a scale of 1 to 4+; the "+" and "-" ratings were translated into numbers by adding and subtracting 0.33 from the assigned value.[2] Attractiveness in this context is judgement-based, combining the value of incentives and the range of potential investors likely to have access to them. The assessment involved a process of inter-country comparison to establish relative positions, using the following principles:

- Tax rates were ignored; a tax holiday in a country with a 30% profit tax rate was deemed as attractive as one in a country with a 20% tax rate.
- Tax holidays were regarded as more valuable than credits related to the amount of the investment, unless the holiday is short and the credit is substantial.
- A tax holiday with no restriction was deemed more valuable than one subject to an upper limit such as the amount of the investment.
- Holidays or credits conditional on reinvestment were regarded as less valuable than those without a requirement to reinvest.

[2] This procedure follows that of the EBRD in the transition indicators

- Profit tax benefits arising in a free trade zone (FTZ) were seen as less attractive than those applying “on-shore” if it appeared that not all categories of business were eligible to operate in the FTZs (e.g. investments targeted at the local market) or that the number of FTZs was limited.
- Tax concessions applicable to individual industries were treated as less attractive than those applying to the whole sector.
- Concessions conditional on location (e.g. in areas of high unemployment) were seen as less attractive than those with no conditions.

Appendix 1 summarizes the assessments and shows the scores.

From a range of sources, including the studies referred to earlier, key stages in the evolution of each country’s tax and incentive system were identified. This information was used to adjust the 2005 scores up or down in the light of movements in the level of incentives offered, giving estimated values for each year between 1994 and 2003; averages for the period were also computed and are shown in appendix 1. Tax rates for years prior to 2005 were obtained from the Heritage Foundation, which drew on data used for its Indices of Economic Freedom (Heritage Foundation, 2005).

4.3 IPAs: data, sources and evaluation method

Information on IPAs has been gathered mainly from the websites of each agency. In a small number of cases, sources such as government or other websites indicated the existence of an agency but no agency website could be located at the time of the study and the agency was therefore treated as inactive.

In the relatively limited number of studies of this area, promotional activities have been measured in a variety of ways. In evaluating the impact of IPAs, Wells and Wint (2000) identified whether or not a country was actively promoting itself in the United States. Morisset (2003) and Morisset and Andrews-Johnson (2004) measured the resources involved, in terms of budgets and manpower. Wint and Williams (2002) utilized the assessment of experts on the effectiveness of IPAs. Charlton and Davis (2004) investigated the relationship between FDI flows to specific industries and the industry targeting strategies of IPAs and therefore did not need to measure total IPA activity. The resource-based approach has the merit of objectivity, but is constrained by availability of information: Morisset made a special survey of selected agencies and gathered information on one year only. The assessment method may risk circularity as the judgment of "effectiveness" could be influenced by the country's success in attracting FDI.

In this study, an assessment-based approach is used to derive a measure of the extent and intensity of IPA activities, concentrating on the three "classical" IPA tasks, i.e. Investor Services, Image Building and Investor Generation; Policy Advocacy is not considered. These are further simplified into two categories: (1) Investor Services and (2) a category combining Image Building and Investor Generation, and therefore covering all activities aimed at attracting investors. Based mainly on its website, each IPA is assessed on (a) whether or not it engages in each of these two categories of activity, assigning the value of 1 if it performs a task and a zero if it does not, and (b) the strength of its activities in each of them, using a "+" or "-" to make distinctions within each category, with "+" or "-" having a value of 0.33. The combined scale ranges from 1, where no activities have been identified, to 3.67, where an agency is judged to perform relatively strongly in both categories. Investor Services are generally listed on IPA websites. Assessment of other activities relies on the impression given by the website (e.g. whether it appears to provide well supported arguments for investing in the country); the existence of activities such as seminars which focus on potential investors; and evidence of a strategic sense expressed, for example, in terms of clear descriptions of priority sectors/industries.

The year of establishment of each agency was identified. In some cases, there were precursor agencies. The score from the process described above was assigned to each year of operation by the agency or its precursor, assuming it took the agency three years from inception to build to its current score.

Averages for the period 1994-2003 were then computed. The results are summarized in appendix 2.

4.4 Limitations of the evaluation methodology

The methodology that generated the values assigned to incentive levels and promotional levels is, as noted, judgement-based. This undoubtedly limits the reliability of the data and the extent to which firm conclusions can be drawn from them. Previous paragraphs have indicated the limitations of existing data, notably the absence of consistent information covering all of the countries under review. The computation of effective tax rates may well be the most useful tool for future research. More effective measurement of IPA activity will probably require data on budgets and resources.

5. Principal trends

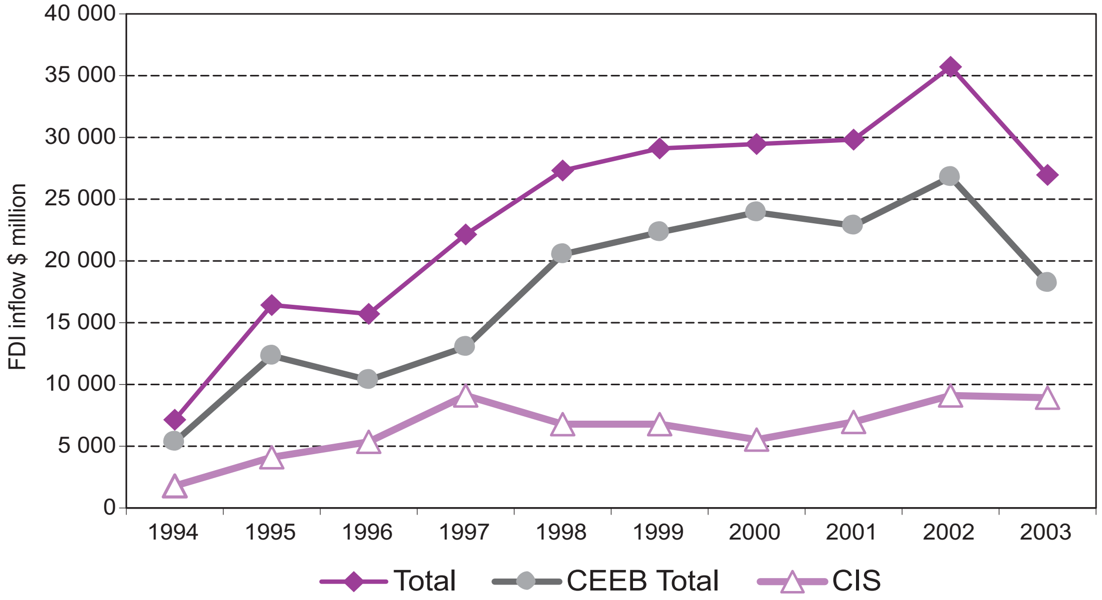
After presenting summary data on FDI, this section reviews the principal trends in taxation rates, the use of incentives and the work of IPAs. In a number of instances, the data are split between the CIS countries and the countries of Central and Eastern Europe and the Baltics (abbreviated as CEEB).

5.1 FDI

Figure 1 shows total annual FDI flows to transition countries, the CEEB countries and the CIS countries for the period 1994-2003. FDI inflows increased until 2002, largely driven by inflows to the CEEB countries. The decline in 2003 was due mainly to the end of privatization in the Czech Republic and Slovakia (UNCTAD, 2004, p. 69).

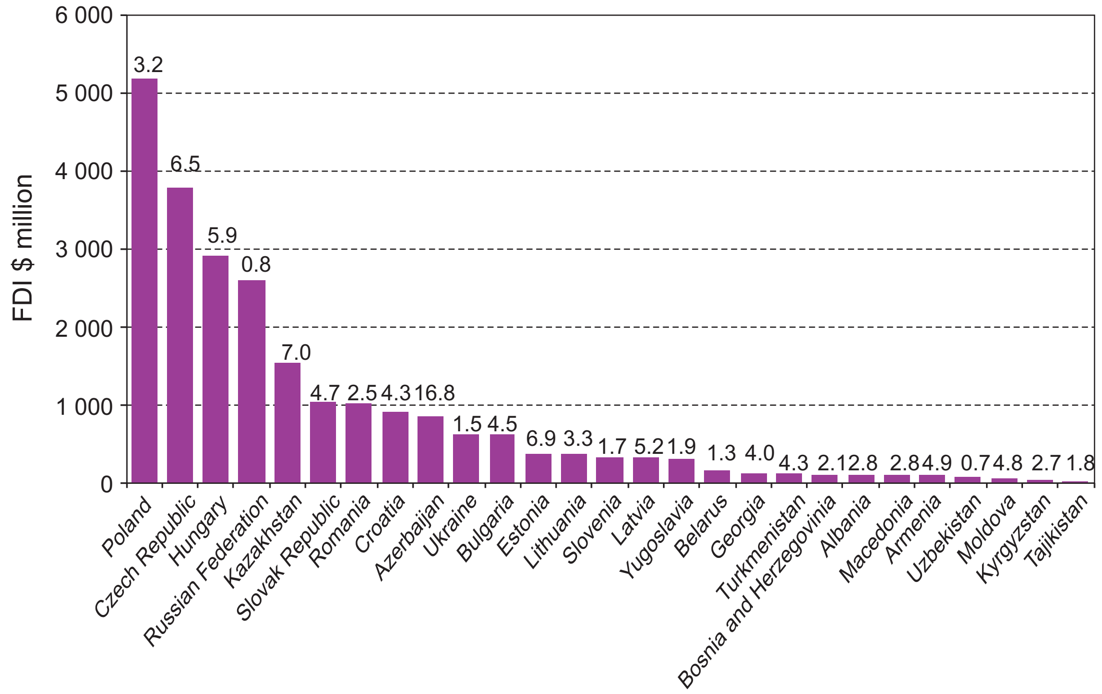
Figure 2 ranks countries according to the value of annual average FDI over the period 1994-2003. Average FDI as a percentage of average GDP is also shown, above the relevant bars. The chart illustrates the high levels of FDI inflows to the countries of Central Europe and to those with significant oil and gas resources.

Figure 1. Annual FDI inflows 1994 – 2003
(Millions of dollars)



Source: UNCTAD (2004).

Figure 2. Annual average FDI inflows as percentage of GDP by country, 1994-2003
(Millions of dollars and per cent)



Source: UNCTAD (2004), World Bank (2005).

5.2 Tax and Incentives

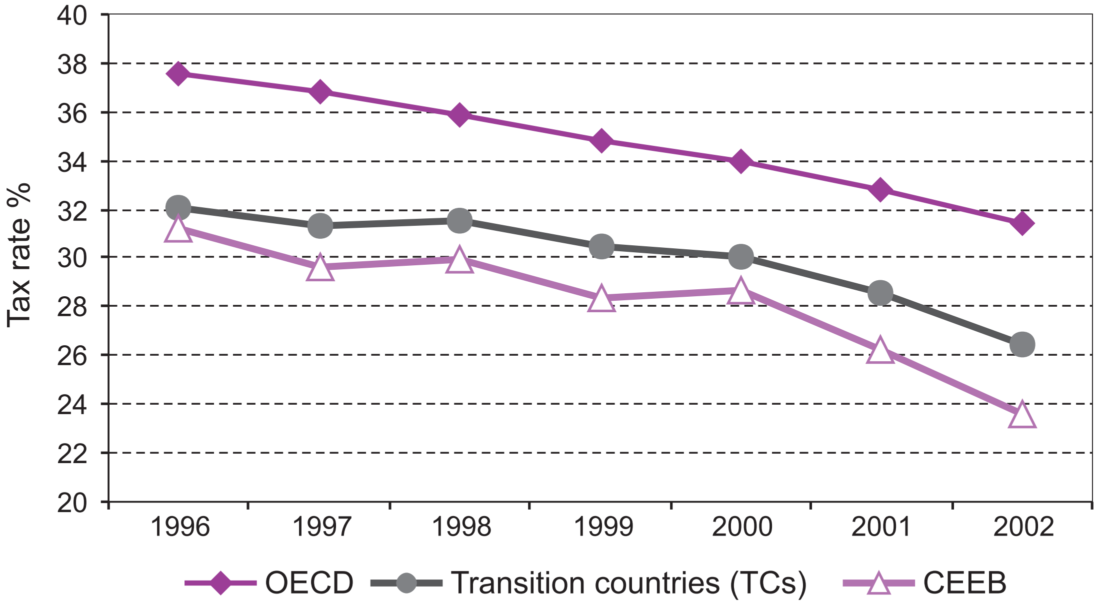
Corporate tax rates have declined significantly since the mid-1990s. Figure 3 shows the average "headline" rates in the OECD, in transition countries as a whole and in the CEEB in the period 1996-2002.

While the OECD average fell from 37.6% to 31.4%, the average in all transition countries went from 32% to 26.4% and that in the CEEB countries fell more sharply from 31.2% to 23.6%. This drop was not accompanied by a reduction in incentives. Figure 4 shows for the CEEB countries the trend of corporate tax rates and the average incentive level (measured as described in section 4) over a slightly longer period. Incentive levels grew strongly and then apparently stabilized.

The evolution of tax rates and incentives in CEEB can be segmented into four broad periods. In the first phase, in the early years of transition, some countries - for example Hungary and the Czech Republic - introduced tax holidays and other incentives. Next, in the first half of the 1990s (mostly before the period shown in figure 4), a number of countries eliminated or restructured incentives, in conjunction with reform of the tax system and, in some cases, reduction of tax rates. Examples are the Czech Republic in 1993 (Gandullia, 2004, p. 16), Estonia in 1994 (Hunya, 2004, pp. 106-107), Hungary in the early 1990s (Gandullia, 2004, p. 15), Lithuania in 1996 (OECD, 2003, p. 183), Poland in 1993 (Sedmihradsky and Klazar, 2002, p. 3), and Slovenia in 1994 (OECD, 2003, p. 184).

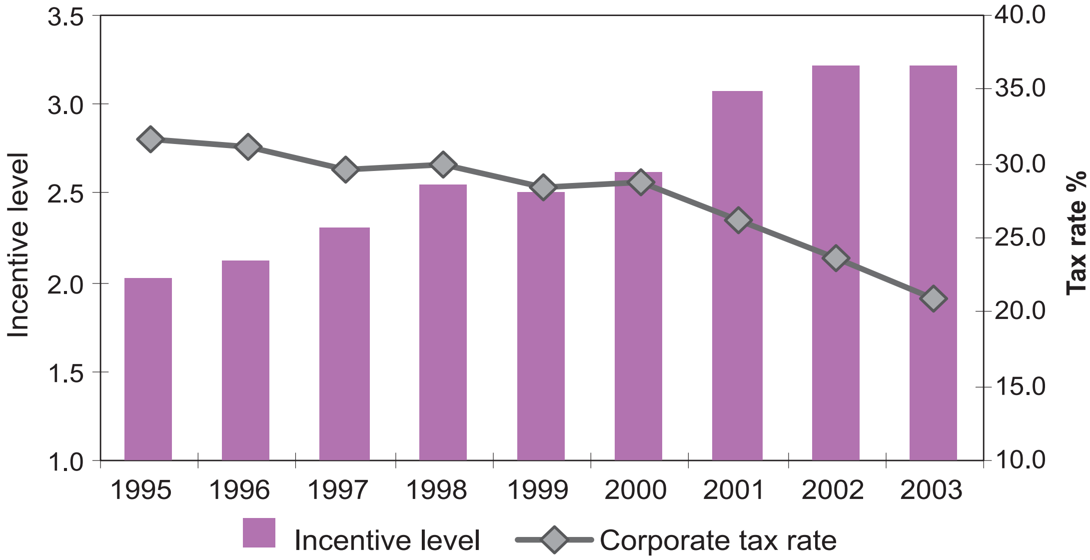
In the third period, largely in the second half of the 1990s, the situation was more complex. Tax rates fell, albeit slowly. A significant development was what has been characterized as "tax competition" between four Central European countries, the Czech Republic, Hungary, Poland and Slovakia (Martinez-Vazquez and McNab, 2000, p. 9; Mitra and Stern, 2002, p. 43; OECD, 2003, p. 181). Hungary was the leader of the process (OECD, 2003, p. 181), with relatively low tax rates from an early stage, "generous tax holidays" (OECD, 2003, p. 181) and free trade zones (UNCTAD, 2002, p. 216). Poland's response

Figure 3. Average corporate tax rates, 1996 -2002
(Per cent)



Sources: OECD (2003), Cato Institute (2002), Heritage Foundation (2005).

Figure 4. Tax rates and incentive levels, CEEB countries, 1995 - 2003
(Per cent and index)



Source: author's calculation based on his survey of country practices.

gathered momentum from 1995, with a network of "special economic zones" in which ten year tax holidays were available (OECD, 2003, p. 181), and with incentives for investment in certain industries (Gandullia, 2004, p. 16) and regions (Hunya, 2000, p. 9). These measures "encourage(d) a similar response in the Czech Republic", starting in 1997 (OECD, 2003, p. 181) and enhanced in 2000. This involved incentives including: tax holidays up to ten years for large new enterprises; tax exemptions for expansion of existing businesses (OECD, 2003, p. 182); and job creation and training grants (Hunya, 2000, p. 9). In 1998, Slovakia was "the last to enter the competition" (OECD, 2003, p. 181), "introducing new and more generous tax holidays and further relaxing the qualifying rules for tax incentives in 1999 and in 2001" (OECD, 2003, p. 181). In the same period, Romania and Bulgaria introduced and repealed a series of incentives described as "bewildering" in the case of Bulgaria (OECD, 2003, p. 121) and "inconsistent" in Romania (OECD, 2003, p. 148). While the three Baltic States "tended to rely more on low rates of CIT (corporate income tax) than on special incentives" (OECD, 2003, p. 182), Lithuania offered significant profit tax reductions for investments in duty free zones (Hunya, 2004, p. 108) and Latvia also established special economic zones offering tax reductions (Hunya, 2004, p. 108; Latvian Investment and Development Agency, 2005). In the countries that had formerly comprised Yugoslavia, there were few incentives during this period.

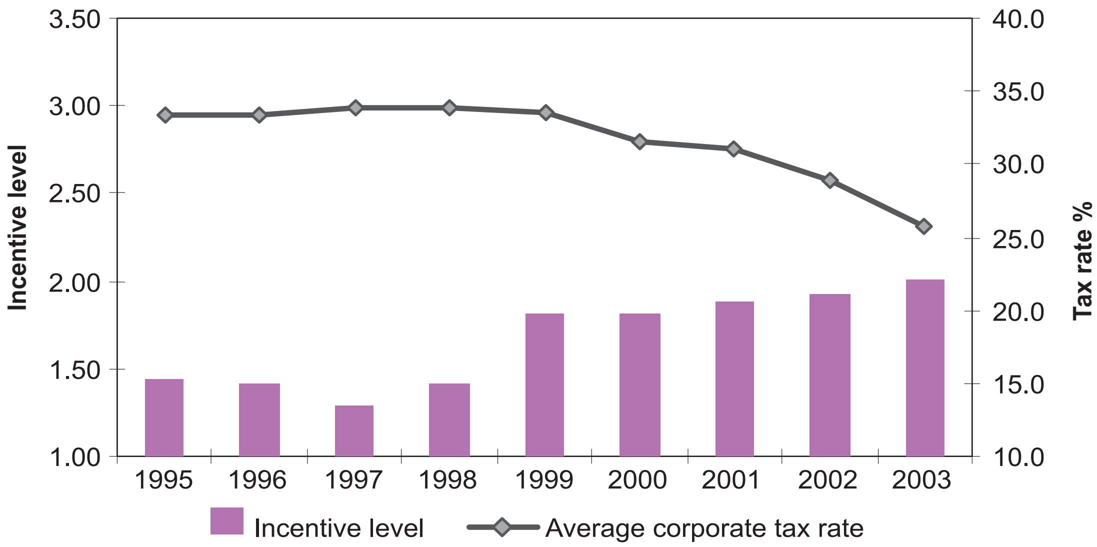
In the fourth phase – the period since 2001 – the level of incentives offered showed signs of stabilizing and may now be in decline, accompanied by rapidly falling tax rates. Incentives offered by countries joining the EU are required to comply with EU competition rules (European Commission, 2001b). For the four Central European countries, this has meant the curtailment of tax holidays, greater emphasis on tax credits and various cash grants – all subject to overall limits on the total value of incentives offered. The greater emphasis on cash grants provides an incentive of a type that "may be particularly attractive from the perspective of a recipient" (UNCTAD, 2002, p. 212). EU membership may also have stimulated some levelling up in countries where incentives were relatively low: for example, since 2001, Latvia has offered partial tax holidays for larger investments - these are compatible with EU rules (Hunya, 2004, p. 107). Bulgaria and Romania have reduced incentives (OECD, 2003, p. 121; FIC, 2002, p. 39), while a more stable environment in the Balkans has led to an expansion of incentives, notably ten year tax holidays in Croatia in 2001 (OECD, 2003, p. 127) and a similar development in Serbia in 2002, following reforms in 2001 (OECD, 2003, pp. 160 and 162).

By 2005, the average tax rate in the CEEB countries had fallen to 17% and the average incentive score was at the same level as 2001, after a small rise in the intervening years.

In the CIS, tax rates have been higher than in the CEEB countries and incentives have been much lower – in some cases non-existent. Compared with the CEEB countries, there is less literature on taxation and incentives and the dates of introduction of some incentives had to be estimated. Figure 5 summarizes the position. Trends are less clear than in the CEEB countries. Early introduction of tax holidays was reversed in some cases - e.g. abolition of tax holidays in Ukraine in 1995 (OECD, 2003,

Figure 5. Tax rates and incentives, CIS countries, 1995 – 2003

(Per cent and index)



Source: author's calculation based on his survey of country practices.

Note: Kazakhstan, Kyrgyzstan and Uzbekistan, whose tax rates for earlier years could not be obtained, are not included.

p. 183) and in Georgia in 1996 (United States Department of Commerce, 2005a). In Russia, tax concessions that were developed in the late 1990s were abolished with the introduction of the new tax code in 2002 (Deloitte Touch Tohmatsu, 2002, p. 2). Overall, in the period since 1999, there appears to have been a modest expansion in incentives, generally through short tax holidays. Countries enhancing incentives have included Kazakhstan in 2004, with a programme of "Investment Tax Preferences" for up to five years for investments in "priority types of activity" (Kazinvest, 2005a), and Moldova in 2002, offering tax holidays ranging from three to five years (OECD, 2003, p. 139). At least seven out of the twelve CIS countries have legislation enabling economic zones that give profit tax reductions but not all zones appear to be operational. By 2005, average tax rates had fallen further to 22.8%, with a slight reduction in average incentive levels compared with 2003.

Table 3 shows the percentage of countries offering the principal categories of incentive. In this table, tax holidays and tax credits are combined into one category. The distinction between tax holidays and tax credits has become blurred, as some tax holidays are partial (e.g. only a part of the tax normally payable is reduced) or are capped in a manner similar to a credit (e.g. the benefit is restricted to an amount equivalent to the value of the investment). The figures for free zones exclude those zones that do not offer reductions in profit tax; also excluded are countries where zones are permitted but do not appear to operate in practice. In this table, no account has been taken of

Table 3. Incentives by type, 2005

% of total countries offering:	CEEB	CIS	All
Tax holiday or tax credits	87%	58%	74%
Free zones with profit tax reduction	53%	58%	56%
Grants	60%	0%	33%
Subsidized locations	40%	8%	26%
No significant incentives	7%	33%	19%

Source: author's own calculation based on his survey of country practices.
Note: The columns add to more than 100%, as countries give more than one type of incentive.

the scale of an incentive; a tax holiday for ten years is treated in the same way as a two-year holiday, unlike in the evaluation process described earlier.

Tax holidays or tax credits are the most popular form of incentives, being used by 74% of all transition countries and by 87% of the CEEB countries. This is consistent with the global picture - "reductions in the standard rates of corporate income tax and tax holidays are the most widely used fiscal incentives" (UNCTAD, 2000, p. 12). Free zones are the second most popular form of incentive, available in 56% of all countries and in 53% of the CEEB countries. Grants are available in 33% of countries, all of which were EU members at the time of the survey except Bulgaria (which joined in 2007) and Croatia (a candidate for membership). The data supports UNCTAD's assessment that "fiscal measures are more common in developing countries, which cannot afford a direct drain on the government budget (while) (d)eveloped countries frequently employ financial incentives such as outright grants" (UNCTAD, 2002, p. 204).

Incentives are generally linked explicitly to "manufacturing" investment or have that effect in practice, as they often have value thresholds that are likely to be reached only with investment in production facilities. Five countries (19%) take a more fine-tuned approach to defining priorities, although it is not always clear how these affect the granting of incentives. In Kazakhstan, where investors in "priority types of activity" are eligible for incentives (Kazinvest, 2005a), the country prioritizes "science intensive and high tech export-oriented production" and "goods and services with high added value" (Kazinvest, 2005b). Serbia lists 16 industries that qualify for higher levels of tax credit, although its tax holidays for larger investments do not appear to have sectoral restrictions (PriceWaterhouseCoopers, 2004, p. 51). The Czech Republic targets its manufacturing incentives on specific manufacturing industries or on investment in "high tech machinery" (PriceWaterhouseCoopers, 2005b). In addition to incentives for manufacturing, the Czech Republic, Hungary and Slovenia have packages for R&D and for services such as call centres and regional corporate centres. A sixth country - Estonia – has priority sectors (Enterprise Estonia, 2005) but may be unable to influence investment in their direction due to its limited use of incentives.

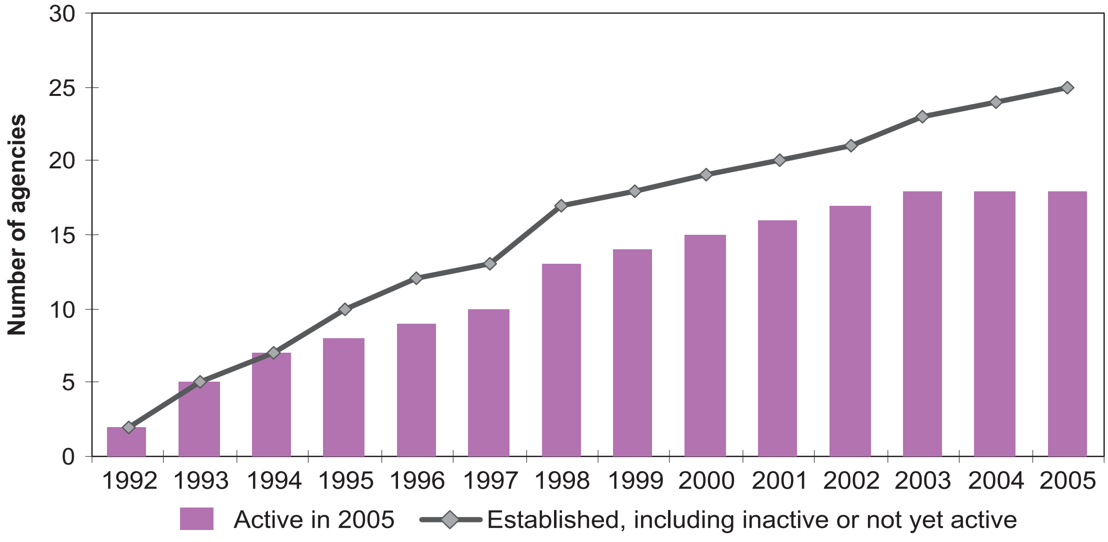
5.3 Promotion

The number of IPAs has increased steadily since the early 1990s. Not all of those IPAs whose establishments have been announced show evidence that they are actually functioning. The trends in the totals of those announced and of those in operation in the years concerned are shown in Figure 6.

The 2005 totals are analysed in table 4. Only 42% of the CIS countries had active agencies compared with 87% of the CEEB countries. Active agencies in the CIS had an average age of 5.4 years while CEEB agencies had an average age of 9.5 years. Use of IPAs is therefore more extensive and longer established in the CEEB countries.

All agencies claim or imply that they perform the three "classical" tasks of IPAs (Investor Services, Image Building, and Investment Generation). In practice, some seem to emphasize Investor Services only. Table 5 presents an assessment of the scope of IPA activity.Those in the "relatively strong

Figure 6. Number of IPAs, 1992 - 2005



Source: author's calculation based on his survey of country practices.

Table 4. Incidence of IPAs in 2005

% of countries with -	CEEB	CIS	All
Active agencies	87%	42%	67%
Agencies inactive or not yet active	13%	50%	30%
No agency	0%	8%	4%
Total	100%	100%	100%

Source: author's own calculation based on his survey of country practices.

investment priority areas. Of these, only one agency - CzechInvest - seems to be engaged in shaping investment priorities and influencing their implementation. Having absorbed other tasks such as SME development and administration of structural funds, it claims to be a "development agency". Its strategic priorities have been clearly articulated (CzechInvest, 2004) and, crucially, it is the sole body in the Czech Republic authorized to submit investment incentive applications to the relevant ministry.

61% of agencies have tasks other than investment promotion, including export promotion (33%) and local business development (39%). Many of these responsibilities have come through mergers between IPAs and other agencies. Whether they contribute to the effectiveness of the agencies' investment promotion role is open to question: Wells and Wint argued that investment and export promotion are significantly different, in terms of contact points, processes and resources and that proposals to combine them "have usually failed" (Wells and Wint, 2000, pp. 170-171).

coverage" category comprise the Czech Republic, Estonia, Hungary and Poland.

61% of active IPAs claim to undertake "Policy Advocacy". Their effectiveness in this task has not been evaluated. As noted above, six IPAs state that their countries have

Table 5. priorities of active IPAs

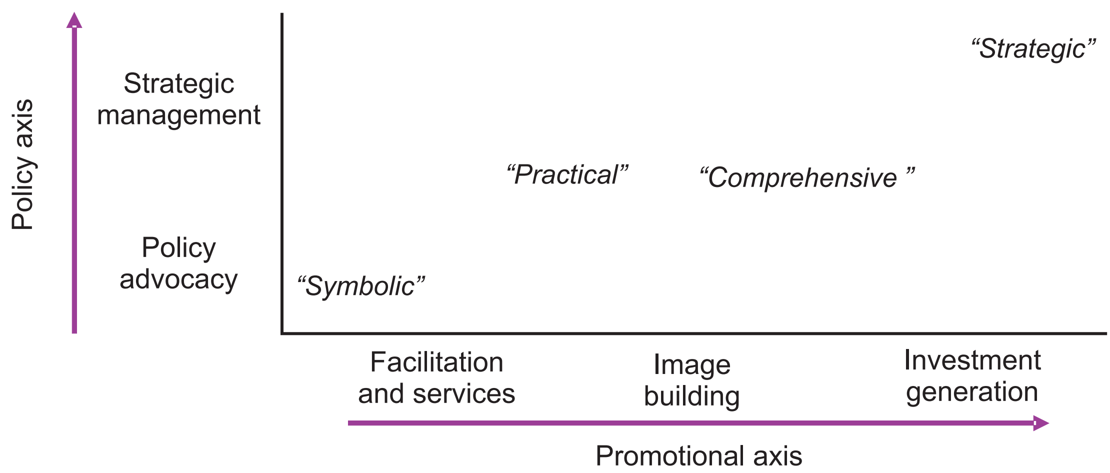
	% of active IPAs
Primary focus on Investor Services	22%
All three functions covered to some degree	56%
Relatively strong coverage of all three functions	22%
Total	100%

Source: author's own calculation based on his survey of country practices.

The foregoing analysis suggests a way of looking at IPAs that goes beyond the conventional classification of their activities. First come what might be described as the "symbolic": agencies that exist legally, may even have some kind of organization and facilities, but don't show any sign of activity. Next, there are the "practical": these major on facilitating new and existing investors, often providing a substantial range of information and services. Armenia's ADA seems to be an example of an agency in this category. The third category might be termed "comprehensive": they perform, or attempt to perform, the three main promotional tasks, providing services and attempting to promote the country to potential investors, with varying degrees of impact; the majority of IPAs are probably in this category. IPAs in the "practical" and "comprehensive" categories are likely also to engage in policy advocacy. Finally, there is the "strategic" category: agencies with a strong sense of the direction in which they want to steer FDI and having the influence and capabilities to advance their goals. The international models include Singapore and Ireland; among transition countries CzechInvest is perhaps the only one that comes into this category. This typology might be represented as in figure 7.

This categorization does not necessarily imply an evolutionary path. Some agencies may deliberately choose to

Figure 7. IPA roles



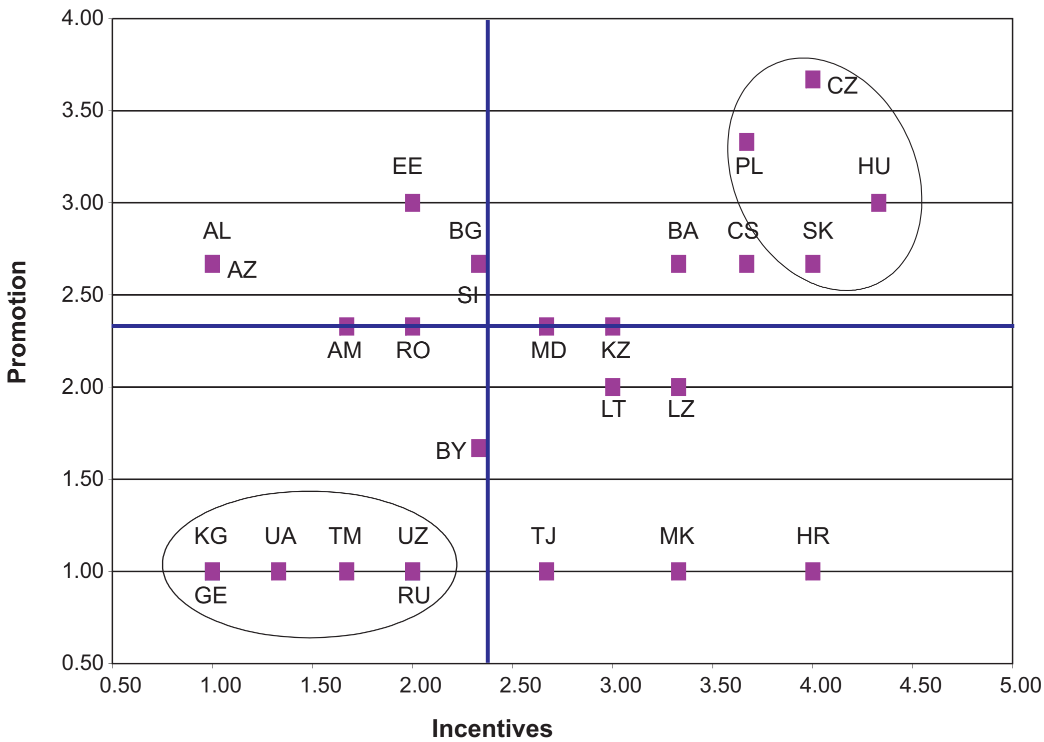
Source: author.

concentrate on services and limited image building; there is evidence that these activities are relatively more cost effective than investment generation (Morisset and Andrews-Johnson, 2004, pp. 32-43).

5.4 Overview of incentives and promotional activity

To complete the review, this section briefly presents the position of individual countries in 2005, in the form of a scatter diagram (figure 8) whose axes measure incentive levels and the extent of promotional activity. Two contrasting groups are highlighted in the chart. On the one hand, there are four Central European Countries (the Czech Republic, Hungary, Poland and Slovakia), which, in 2005, gave relatively high levels of incentives and had active IPAs, a stance they had maintained for some time. On the other, there is a larger group of CIS countries with few incentives and without IPAs. There are some extreme positions: Estonia with few incentives (but low taxes) and an active IPA, Croatia with substantial incentives but no

Figure 8. Country Scores, Incentives and Promotion, 2005



Source: author.

IPA in the period surveyed. Of the remainder, some such as Slovenia, Lithuania and Latvia have followed a reasonably consistent course over time while others, in the years prior to 2005, underwent significant policy shifts, whether towards higher incentives (e.g. Croatia, Bosnia and Herzegovina, Serbia and Montenegro) or fewer (e.g. Romania).

6. Factors shaping incentive and promotion policies

This section assesses whether the data shed light on the factors that have influenced the policies of transition countries towards incentives and promotional activities.

It was hypothesized earlier (Section 2) that incentives were most likely to be offered in order to offset disadvantages in the business environment, such as those that arise when the transition process is incomplete (described as the "transitional hypothesis") or profit taxes are high (the "tax hypothesis"). An alternative perspective would see incentive levels as driven by international competition for efficiency-seeking investment (described as the "competitive hypothesis"). The "transitional" and "tax" hypotheses gain only limited support from the data reported above. There is evidence from some CEEB countries that incentives were introduced in the early years of transition and subsequently withdrawn as tax systems were reformed and rates reduced. But the dominant trend is a progressive increase in the level of incentives against the background of reductions in tax rates and progress in transition. Explanations in terms of the "competitive hypothesis" seem plausible, at least for the four countries – the Czech Republic, Hungary, Poland and Slovakia - reported as having engaged in "tax competition" in the late 1990s. Recent stabilization of incentive levels - and, in some cases, reduction - appears linked to EU rules and may also reflect a shifting of competition from incentives to tax rates.

As noted, a "transitional hypothesis" might also seem relevant to the development of IPAs, in that promotion could be particularly important in the early stages of transition when investors might be unaware of the opportunities or might need assistance in establishing their operations. In practice, however, the number and scope of active IPAs have grown as the process of transition has advanced, giving support to the alternative hypothesis (the “marketing hypothesis”) under which the level of promotional activity is linked to the advantages a country can offer to potential investors.

The relationship between incentive levels and promotional activity on the one hand and a range of possible explanatory variables such as transition progress on the other might lend itself to formal econometric analysis. This has not been undertaken here, reflecting the approximate nature of the quantification of some of the relevant variables, especially the measures of incentives and of promotional activity. Instead, country behaviour is explored briefly by examining incentive levels and IPA activity in a number of country clusters. Countries have been grouped on the basis of similarities in a small number of variables that may be relevant to attractiveness to foreign investors in the context of transition, comprising:

- Transition progress, defined as progress towards an “industrialized market economy” (using the EBRD’s terminology) and measured as the average of the EBRD transition scores for each country in the period 1994-2003, under the headings: large-scale privatization; small-scale privatization; governance and enterprise restructuring; price liberalization; trade and foreign-exchange liberalization; competition policy; banking reform and securities markets (*source*: EBRD transition reports).
- Political stability, using a measure taken from the World Bank’s set of Governance Indicators and averaged for the period 1996-2002 (*source*: World Bank, 2004).
- Proximity to sources of FDI, measured by the average distance between the capital city of the country and the capitals of the three nearest potential sources for FDI, which are defined as EU capitals, Moscow (for all countries except Russia) and Istanbul.
- Resource endowment, defined as whether or not the country has a “rich” natural resource endowment (*source*: De Melo *et al.*, 1997, table 1).

Five principal clusters were identified, and are shown in table 6. For each cluster, the average level of taxation, incentives and IPA activity in the period 1994-2003 is also shown. Incentives and IPA activity have been grouped into three categories, "high", "medium" and "low/no" based on the scores computed for this article. Average corporate tax rates have been converted to a scale used by the Heritage Foundation, in which taxes below 15% are rated as "very low", taxes at or above 36% are rated "very high" and intermediate positions are rated "low", "moderate" and "high" (Heritage Foundation, 2005, p. 63). More extensive information, including individual country data, is given in appendix 3.

Table 6. Summary of country clusters and scores

Group	*(comment)*	Members	Avge. level 1994-2003		
			Tax	Incentives	IPA activity
1	*(more stable and advanced in transition and closest to FDI sources)*	Czech Republic, Estonia, Hungary, Poland, Slovakia, Slovenia	High	High	High
2		Bulgaria, Croatia, Latvia, Lithuania, Romania.	High	Medium	Medium
3		Albania, Armenia, Belarus, Bosnia & Herzegovina, Macedonia, Moldova, Ukraine, Serbia and Montenegro	High	Low/No	Low/No
4	*(less stable or less advanced in transition and furthest from FDI sources)*	Georgia, Kyrgyzstan, Tajikistan, Uzbekistan	V high	Low/No	Low/No
5	*(resource rich – would otherwise be in 3 or 4)*	Azerbaijan, Kazakhstan, Russian Federation, Turkmenistan	V high	Low/No	Low/No

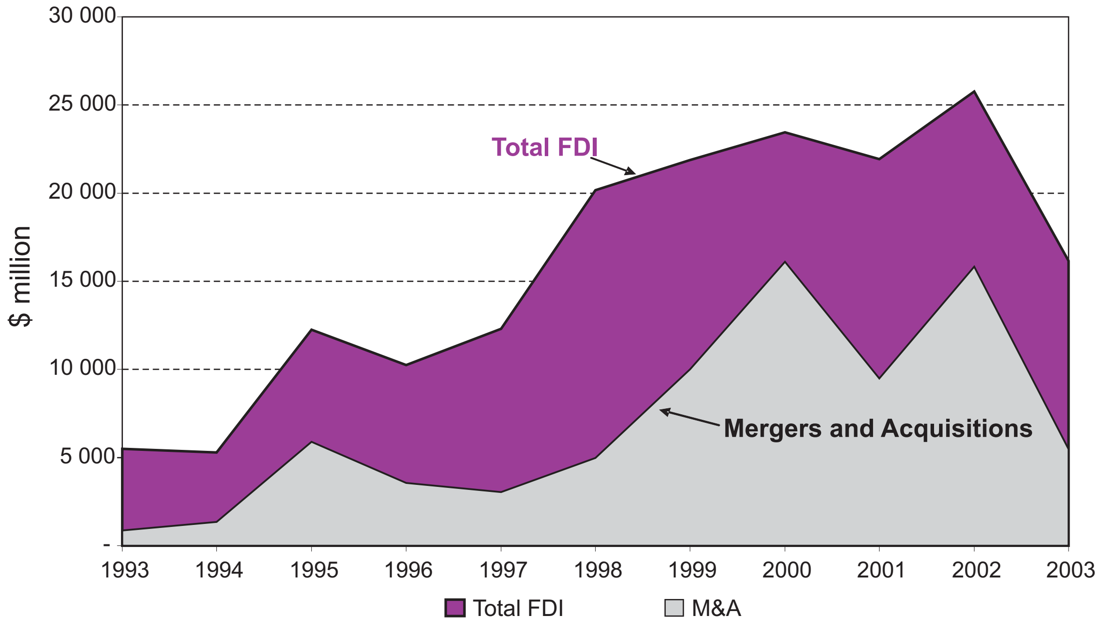
Source: author's analysis based on his survey of country practices.

There are differences between the clusters with respect to the level of incentives offered and the extent to which IPAs are used, but there doesn't appear to be a marked difference in tax levels. The resource-rich countries (Cluster 5) may perhaps be viewed as a special case, in that they could presumably attract FDI into their oil and gas and mineral industries (and perhaps other areas also) without needing to promote themselves or give incentives; it may also be that the special regimes some of them operate in the oil and gas industry were used in such a way as to offer attractive terms, at least to first movers. Leaving them aside, the exercise suggests that in the period under consideration (1994-2003) the countries that were less advanced in transition, less stable or further from potential sources of FDI were also less likely to offer high levels of incentive and to engage in promotional activity. These countries appear to have had disadvantages that could deter investors, but they have offered fewer incentives and have promoted themselves less actively (if at all) than countries that have relatively more attractive business environments. The interaction between tax rates and incentives levels is less clear: clusters with "very high" taxation seem to have offered little or no incentives and the three clusters classified as having "high" taxation offered very different incentive levels, ranging from high to low. Thus high or very high tax rates cannot be seen as an explanation of high incentives. The picture that emerges is that levels of incentives and of promotional activity among transition countries have been shaped by factors other than relative disadvantage.

A positive identification of the factors behind country policies is more complex, because practices vary, even within clusters, and some countries have changed their policies over time. One approach would be to explain trends in the use of incentives in terms of an initial focus on privatization followed, at a later stage, by the encouragement of greenfield investment. It could be argued that a formalized system of incentives was not needed in order to attract investors in privatizations, who could instead be influenced by the acquisition price and specific contractual terms. An incentive system, on the other hand, would become more relevant when attention shifted to greenfield investors. This interpretation can be assessed by considering mergers and acquisitions (M&A) and total FDI flows, as presented by UNCTAD.[3] If reported M&A inflows are assumed to be predominantly in respect of privatizations – a reasonable assumption at least in the initial years of transition – they might be expected to decline in absolute terms and as a percentage of total FDI. The actual picture is more complex, both in total and at country level. Significant privatization inflows occurred after the start of "tax competition" in the second half of the 1990s. Greenfield investment seems to have been substantial and on an increasing trend from an early stage. Figure 9 shows the values involved for transition countries as a whole.

Figure 9. Total FDI inflows to transition countries and M&A inflows, 1993 – 2003

(Millions of dollars)



Source: UNCTAD (2004).

[3] There are limitations attached to linking M&A and total inflows, as M&A data are not always consistent with total FDI reporting. While FDI figures are derived from balance-of payments data, the M&A data are sourced separately. The M&A figures represent the total amounts of the transactions involved, recorded at the time the relevant deals are closed, but these are not always paid in a single year. The FDI inflows represent the value of transactions in the year in question (see UNCTAD, 2005, pp. 301-302 for an elaboration of the differences between the two series).

It seems that policies towards incentives and promotion can best be explained in terms of a complex of factors. The most crucial element may well be a decision to focus strongly on attracting efficiency-seeking investment, either because market-seeking FDI (whether greenfield or acquisition of privatized firms) was tailing off or because of an intensified focus on growth following the transition recession. This doesn't explain the consistency with which some countries have developed their incentive systems, compared with the inconsistent policies followed by others. It may be that success in actually attracting investment (resulting from a range of factors, including institutional and locational advantages) may reinforce the initial commitment to attracting FDI and ensure the continuation of the relevant policies, including the offering of incentives. Effective IPAs, with links to an expanding number of existing and potential investors, may develop an influence on policy formulation, minimizing radical shifts in direction, protecting or even enhancing incentives, and embedding attitudes favourable to FDI within key sectors of government and more widely.

This account seems to fit the experience of countries in the first and second clusters. The Czech Republic, Hungary, Poland and Slovakia, which were relatively advanced in transition (as well as being close to investment sources) made decisive commitments to encouraging FDI through a range of policies, including an escalating level of financial and fiscal incentives, in the mid- to late-1990s. The development of effective IPAs and the accumulation of an "installed base" of FDI may have ensured the continuation and indeed enhancement of investor-friendly policies. Estonia's approach can be analysed in broadly similar terms: its choice of low taxes rather than incentives represents an equally decisive commitment to encouraging FDI; significantly, it has an experienced IPA, which attaches high priority to "aftercare of existing investors" (UNCTAD, 2002, p. 213). Romania in the 1990s illustrates a different set of circumstances. It offered "a multitude of overlapping incentives", subject to frequent change (OECD, 2003, p. 148), subsequently scaled back incentives and recently introduced a low overall tax rate. The earlier instability might be linked to an uncertain attitude to FDI, perhaps aggravated by weak feedback mechanisms; actual FDI was relatively low in the period concerned and it may be significant that the Romanian IPA underwent a number of changes and reorganizations until its relaunch in 2002, suggesting that its voice in policymaking was weak.

7. Conclusions

While most transition countries have offered investment incentives at some point, there are considerable differences in the extent to which they have done so and country policies have varied over time; generalizations, therefore, have to be heavily qualified. Tax rates are an important background to incentives and here conclusions can more easily be drawn – corporate tax rates have been falling since the mid 1990s and especially since the year 2000. There was a significant increase in the average level of incentives since the mid-1990s; this rise was most marked in the period from 1997 to 2001/2002, occurred mainly in the CEEB countries and took place despite the fall in corporate tax rates. The most common form of incentive is a tax holiday or investment tax credit, followed by free zones; only a minority of countries – generally those with higher income levels – offer cash grants. Incentives have largely been targeted at manufacturing, with varying degrees of discrimination between industries, while some countries have recently begun to offer special packages for investment in R&D and certain services. EU membership has restricted the incentives that some CEEB countries can offer. A recent further fall in corporate tax rates may herald a new phase in which incentives play a lesser role in FDI attraction. The widespread lowering of tax rates brings into question whether an elaborate apparatus of fiscal and financial incentives continues to be necessary.

IPA numbers have grown steadily since the early 1990s, although some agencies do not appear to be active in any meaningful sense. When these are excluded, IPAs are largely a CEEB phenomenon – only 40% of the CIS countries have an active agency compared with 87% of the CEEB countries. Most agencies claim to undertake the main promotional tasks into which IPA activities are conventionally classified: Investor Services, Image Building, and Investment Generation. 60% also engage in “Policy Advocacy” – working to improve the investment climate – and a similar percentage undertake non-IPA activities, such as export promotion - a recent development that may carry the risk of loss of focus. Performance of the three main tasks varies in quality: a minority appear to have chosen, sensibly, to focus on investor services and facilitation; a similar minority appears to perform relatively well across the spectrum; and there is a larger group that probably still needs to find an effective way to deliver the more proactive functions, notably investment generation. International best practice suggests that there is a further “strategic” dimension to IPA activity: at least one agency – CzechInvest - appears to have moved to this level, with a clear strategy, sharply defined sectoral priorities and an active involvement in the negotiation of incentives with individual investors. The wide divergence in the role and effectiveness of IPAs has policy implications, including whether limited resources are being spread over too wide a range of tasks; whether it is desirable to undertake tasks additional to investment promotion; and whether some agencies are positioned in such a way as to make an appropriate and effective input to official policy in relation to FDI.

This article has attempted to understand the factors that have shaped policy towards incentives and promotional activity. There was no evidence that incentives have been influenced by a need to compensate for inadequacies in the business environment, high tax rates or other relative disadvantages, such as distance; if anything the reverse appeared to be the case – incentive levels increased as countries made progress towards a market economy and reduced their tax rates. Countries more advanced in transition are more likely to have active promotion agencies than the laggards. It seems likely that policies have been shaped by the seriousness and consistency of a country’s commitment to encouraging efficiency-seeking, export-oriented FDI; competition between countries; and mechanisms, including “policy advocacy” by IPAs, that reinforce or even amplify initial policy decisions that have proved successful.

The measures used here to evaluate incentive levels and promotional activities have shown their limitations. At worst, their value may be illustrative rather than analytical; at best they need further refinement - this applies particularly to promotional activity.■

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Appendix 1. Tax Rates and Investment Incentives 2005

Country	Tax rate on corporate profits % 2005	Principal Incentives 2005: Tax holiday	Tax credits	Grants	Subsidized locations	Free Zones with profit tax reductions	Comment	Score 2005	Average score 1994-2003
Albania	23%						No significant incentives identified	1	1.67
Armenia	20%	X					Limited tax holiday only (2 years)	2-	1.34
Azerbaijan	24% (a)						Production sharing agreements in oil sector may operate as incentives - not taken into account here	1	1.00
Belarus	24% (b)	X (f)				X	Free zones with five year tax holiday appear to be the main incentive	2+	2.34
Bosnia & Herzegovinia	30% (c)	X	X			X	Tax holidays, both in free zones and onshore (5 yrs) plus tax credit for reinvested profit provide significant incentive.	3+	2.17
Bulgaria	15%	X	X	X	X	X	Conditions attached to incentives (location in areas of high unemployment, reinvestment profit) may reduce their advantage	2+	2.60
Croatia	20%	X	X	X		X	10 year tax holidays represent a significant benefit	4	1.90
Czech Republic	26% (d)	X		X	X		A significant and wide range of incentives, now constrained by EU rules	4	3.00
Estonia	0% (e)			X			Limited incentives, as focus is on low tax rate	2	1.70
Georgia	20%						Reforms of tax system being prepared	1	1.30
Hungary	16%		X	X	X	X	EU rules have constrained the generous range of incentives previously offered but the current package, especially the development tax incentive, appears to provide considerable scope, albeit with complex rules and overall limits.	4+	3.73
Kazakhstan	30%	X	X		X	X	A significant range of incentives, whose attractiveness may be lessened by the operation of the Government's system of priority sectors. Accounts of what is available differ.	3	1.00
Kyrgyzstan	20%						No incentives identified	1	1.80
Latvia	15%		X	X		X	Tax credits, grants and free zones offer a significant range of incentives which, however, seem more limited than some other EU members	3+	2.63
Lithuania	15%		X			X	The main incentive appears to be the generous regime in FEs	3	3.00

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Appendix 1. Tax Rates and Investment Incentives 2005

Country	Tax rate on corporate profits % 2005	Principal Incentives 2005: Tax holiday	Tax credits	Grants	Subsidized locations	Free Zones with profit tax reductions	Comment	Score 2005	Average score 1994-2003
Macedonia	15%	X	X			X	Short tax holidays "onshore", tax credits and long tax holidays in free zones represent a significant range of incentives, at least on paper.	3+	1.70
Moldova	18%	X				X	Relative attractiveness of tax holidays reduced by five year duration and reinvestment requirement	3-	2.07
Poland	19%		X	X	X	X	While tax exemptions appear not to be given outside SEZs, investment grants and the wide use of SEZs imply an attractive range of incentives, capped, however, by EU limits.	4-	3.60
Romania	16%		X		X	X (g)	The phasing out of incentives given in free zones and in disadvantaged areas means that the overall level of incentives is relatively modest.	2	3.10
Russian Federation	24%		X			X	Modest regional incentives and reinvestment requirement in FEZs imply a relatively low overall level	2	1.84
Serbia & Montenegro	10%	X	X				Up to 10 year tax holidays for large investments and various tax credits imply a high level of incentive.	4-	1.54
Slovak Republic	19%	X	X	X	X		The ten year reduction and various grants represent a significant level of incentive	4	2.84
Slovenia	25%		X	X			Dividend restrictions appear to limit value of relatively modest tax credits.	2+	2.77
Tajikistan	30%	X				X	In principle tax holidays and Free Zones represent significant incentives but it is not clear how these work in practice	3-	1.50
Turkmenistan	20%	X				X	In principle there seems to be a willingness to grant incentives, some on a case by case basis, but operation in practice was not established	2-	1.67
Ukraine	25%					X (h)	Moratorium on new projects in SEZs means that overall level of incentives is limited	1+	1.87
Uzbekistan	15%	X	X			X	Incentives are available on a case by case basis but requirements are described as ambiguous and cumbersome	2	1.70

Tax rate notes (a) Separate regime for oil (b) 30% for banks (c) 10% in Republika Srpska (d) 24% from 2006 (e) 24% payable on distribution of profit Incentive notes (f) Applies only to companies esta blished before 2005 (g) profit tax concession applies to existing investors; ends in 2006 (h) moratorium on new projects

Appendix 2. Investment promotion agencies: summarized data

		Status: None identified	Status: Apparently inactive / not yet active	Status: Active	Years in operation (active agencies only)	Scoring 2005: Base	Scoring 2005: Services	Scoring 2005: Promotion	Scoring 2005: **Total**	**Average score 1994-2003**	Explicit policy advocacy / liaison role	Other tasks: Exports	Other tasks: Local business development	Other tasks: Other	Other tasks: No other task
Albania				X	3	1	1	1-	**2.67**	**1.20**	X	-	-	-	X
Armenia				X	7	1	1+	0	**2.33**	**1.70**	X	X	-	-	-
Azerbaijan				X	2	1	1-	1-	**2.67**	**1.10**	X	-	-	-	X
Belarus				X	4	1	1-	0	**1.67**	**1.07**	-	-	-	-	X
Bosnia & Herzegovinia				X	6	1	1	1-	**2.67**	**1.64**	X	-	X	-	-
Bulgaria				X	10	1	1	1-	**2.67**	**2.00**	-	-	-	-	X
Croatia			X		na	1	na	na	**1.00**	**1.00**	na	na	na	na	na
Czech Republic				X	13	1	1+	1+	**3.67**	**3.37**	X	-	X	-	-
Estonia				X	11	1	1	1	**3.00**	**2.70**	-	X	X	-	-
Georgia			X		na	1	na	na	**1.00**	**1.00**	na	na	na	na	na
Hungary				X	12	1	1	1	**3.00**	**2.80**	-	-	X	-	-
Kazakhstan				X	7	1	1-	1-	**2.33**	**1.60**	-	-	-	-	X
Kyrgyzstan		X			na	1	na	na	**1.00**	**1.00**	na	na	na	na	na
Latvia				X	12	1	1	0	**2.00**	**2.00**	X	-	X	-	-
Lithuania				X	8	1	1	0	**2.00**	**1.70**	-	X	-	-	-
Macedonia			X		na	1	na	na	**1.00**	**1.00**	na	na	na	na	na
Moldova				X	7	1	1-	1-	**2.33**	**1.70**	X	X	X	-	-
Poland				X	13	1	1+	1	**3.33**	**2.90**	X	X	-	X	-
Romania				X	11	1	1-	1-	**2.33**	**1.80**	X	-	-	-	X
Russian Federation			X		na	1	na	na	**1.00**	**1.00**	na	na	na	na	na
Serbia & Montenegro				X	4	1	1	1-	**2.67**	**1.30**	X	X	-	-	-
Slovak Republic				X	11	1	1	1-	**2.67**	**2.04**	-	-	X	-	-
Slovenia				X	9	1	1	1-	**2.67**	**2.13**	X	-	-	-	X
Tajikistan			X		na	1	na	na	**1.00**	**1.00**	na	na	na	na	na
Turkmenistan			X		na	1	na	na	**1.00**	**1.00**	na	na	na	na	na
Ukraine			X		na	1	na	na	**1.00**	**1.00**	na	na	na	na	na
Uzbekistan			X		na	1	na	na	**1.00**	**1.00**	na	na	na	na	na
Totals:								Mean scores:			Totals:				
CEEB	15	0	2	13	9.5				**2.49**	**1.97**	8	5	6	1	4
CIS	12	1	6	5	5.4				**1.53**	**1.18**	3	1	1	0	3
Total	27	1	8	18	8.3				**2.06**	**1.62**	11	6	7	1	7
% of total countries											% of active countries				
CEEB	100	0%	13%	87%							62%	38%	46%	8%	31% *
CIS	100	8%	50%	42%							60%	20%	20%	0%	60%
Total	100	4%	30%	67%							61%	33%	39%	6%	39% *

* Adds to more than 100% due to agencies with more than one extra task

Appendix 3. Host Country characteristics and levels of taxation, incentives and promotional activity

Cluster	Country	Cluster characteristics				Average levels, 1994 - 2003						2005 levels		
		Transition Progress (average, 1994-2003)	Political Stability (average, 1994-2003)	Proximity (km)	Natural Resources	Corporate Tax %	Corporate Tax Group	Incentives Score	Incentives Group	Promotional Activity Score	Promotional Activity Group	Tax rate %	Incentives Score	Pomotion Score
1	Czech Republic	3.50	3.45	375	0	36.5%	V high	3.00	High	3.37	High	26.0%	4.00	3.67
1	Estonia	3.45	3.34	433	0	18.0%	Low	1.70	Low/No	2.70	High	** 0.0%	2.00	3.00
1	Hungary	3.60	3.44	574	0	18.0%	Low	3.73	High	2.80	High	16.0%	4.33	3.00
1	Poland	3.45	3.21	578	0	36.0%	V high	3.60	High	2.90	High	19.0%	3.67	3.33
1	Slovak Republic	3.35	3.25	466	0	36.5%	V high	2.84	High	2.04	Medium	19.0%	4.00	2.67
1	Slovenia	3.25	3.57	501	0	26.5%	Moderate	2.77	Medium	2.13	Medium	25.0%	2.33	2.67
	Cluster 1 average	*3.43*	*3.38*	*488*	*0*	*28.6%*	*High*	*2.94*	*High*	*2.66*	*High*	*17.5%*	*3.39*	*3.06*
2	Bulgaria	2.85	2.87	617	0	34.5%	V high	2.60	Medium	2.00	Medium	15.0%	2.33	2.67
2	Croatia	3.10	2.98	522	0	29.0%	High	1.90	Low/No	1.00	Low/No	20.0%	4.00	1.00
2	Latvia	3.10	3.17	506	0	25.0%	Moderate	2.63	Medium	2.00	Medium	15.0%	3.33	2.00
2	Lithuania	3.20	3.11	693	0	27.0%	High	3.00	High	1.70	Medium	15.0%	3.00	2.00
2	Romania	2.75	2.83	683	0	35.5%	V high	3.10	High	1.80	Medium	16.0%	2.00	2.33
	Cluster 2 average	*3.00*	*2.99*	*604*	*0*	*30.2%*	*High*	*2.65*	*Medium*	*1.70*	*Medium*	*16.2%*	*2.93*	*2.00*
3	Albania	2.65	2.15	622	0	29.5%	High	1.67	Low/No	1.20	Low/No	23.0%	1.00	2.67
3	Armenia	2.50	2.22	1639	0	25.0%	Moderate	1.34	Low/No	1.70	Medium	20.0%	1.67	2.33
3	Belarus	1.65	2.51	743	0	29.5%	High	2.34	Medium	1.07	Low/No	24.0%	2.33	1.67
3	Bosnia & Herzegovinia	1.70	2.03	610	0	30.0%	High	2.17	Medium	1.64	Low/No	30.0%	3.33	2.67
3	Macedonia	2.75	1.91	618	0	19.0%	Low	1.70	Low/No	1.00	Low/No	15.0%	3.33	1.00
3	Moldova	2.55	2.37	898	0	30.0%	High	2.07	Medium	1.70	Medium	18.0%	2.67	2.33
3	Serbia & Montenegro	1.65	1.34	672	0	23.0%	Moderate	1.54	Low/No	1.30	Low/No	10.0%	3.67	2.67
3	Ukraine	2.25	2.34	953	0	30.0%	High	1.87	Low/No	1.00	Low/No	25.0%	1.33	1.00
	Cluster 3 average	*2.21*	*2.11*	*844*	*0*	*27.0%*	*High*	*1.84*	*Low/No*	*1.33*	*Low/No*	*20.6%*	*2.42*	*2.04*
4	Georgia	2.40	1.37	1602	0	20.0%	Low	1.30	Low/No	1.00	Low/No	20.0%	1.00	1.00
4	Kyrgyzstan	2.80	2.48	3517	0	31.0%	High	1.80	Low/No	1.00	Low/No	20.0%	1.00	1.00
4	Tajikistan	1.90	0.60	3409	0	48.0%	V high	1.50	Low/No	1.00	Low/No	30.0%	2.67	1.00
4	Uzbekistan	2.25	1.93	3258	0	34.5%	V high	1.70	Low/No	1.00	Low/No	15.0%	2.00	1.00
	Cluster 4 average	*2.34*	*1.60*	*2947*	*0*	*33.4%*	*V high*	*1.58*	*Low/No*	*1.00*	*Low/No*	*21.3%*	*1.67*	*1.00*
5	Azerbaijan	2.05	1.80	1984	1	32.5%	High	1.00	Low/No	1.10	Low/No	24.0%	1.00	2.67
5	Kazakhstan	2.45	2.77	3646	1	30.0%	High	1.00	Low/No	1.60	Low/No	30.0%	3.00	2.33
5	Russian Federation	2.75	1.95	1230	1	35.0%	V high	1.84	Low/No	1.00	Low/No	24.0%	2.00	1.00
5	Turkmenistan	1.35	2.63	2688	1	37.0%	V high	1.67	Low/No	1.00	Low/No	20.0%	1.67	1.00
	Cluster 5 average	*2.15*	*2.29*	*2387*	*1*	*33.6%*	*V high*	*1.38*	*Low/No*	*1.18*	*Low/No*	*24.5%*	*1.92*	*1.75*

** *0% tax rate is for undistributed profit; distributions are taxed at 24%*