International Science Index Vol:4, No:6, 2010 waset.org/Publication/364

Tax Incentives in Western Balkan Countries

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***Abstract*—**This paper provides an analysis of corporate income tax (CIT) incentives in the Western Balkan countries: Slovenia, Croatia, Serbia, Montenegro, Macedonia and Albania. Western Balkan countries, as other transition and developing countries, use large number of the corporate income tax incentives (CIT) to attract foreign investments and to stimulate economic activity. The main goal of this paper is to investigate how often these countries use CIT incentives and provide review of existing tax incentives in Western Balkan countries. Paper will focus on reduced CIT rates, tax holidays, and other investment incentives which imply incentives like accelerated depreciation, tax allowances and tax credits.

***Keywords*—**tax incentives, tax rate, tax holidays, Western Balkan countries

I. Introduction

TAX systems, generally, in the world, and especially in those European transition countries that include Western Balkan countries, have undergone significant reforms over the last two decades which made their tax systems more consumption oriented. These reforms were partly a result of internal changes, but, on the other hand, were also significantly influenced by the globalization process and the increased international mobility of capital. According to Rose and Wiswesser [14], two of the creators of such a taxation concept, the shifting of the tax systems in the direction of a consumption-based personal income tax (PIT) and corporate income tax (CIT) was necessary in transition countries as they suffered from a lack of capital. Such a CIT concept was automatically accompanied by a relatively low tax burden. Meanwhile, some of these countries completely or partially gave up the practice of a consumption-based CIT. However, through the implementation of various tax incentives the practice of a relatively low corporate tax burden was nevertheless retained until today, along with the practice of using CIT to stimulate economic activity.

The basic goal of this paper is to investigate the presence of tax incentives within the scope of CIT in Western Balkan countries. According to available data, analysis will focus on Slovenia, Croatia, Serbia, Montenegro, Macedonia and Albania. To this effect, the paper is divided into four parts. Following the introduction, the second part of the paper gives an analysis of some general issues and a short review of relevant literature concerning tax incentives. The third part of the paper includes an overview of CIT incentives used in Western Balkan countries. Besides CIT rate, a numerous number of tax holidays and other investment incentives will be analyzed. The fourth part brings the conclusion.

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II. Tax Incentives: Some General Issues and Short Literature Review

A large number of different tax incentives are implemented within various tax forms in the world today. However, when speaking of tax incentives in general, one usually refers to incentives in the scope of CIT. Relevant literature most commonly classifies tax incentives in the scope of CIT into the following three basic groups [16], [3]: 1) reduced CIT rates, 2) tax holidays, and various 3) investment incentives in the broader sense, which imply incentives like accelerated depreciation, investment allowances and investment tax credits.

The various purposes of their implementation may include the stimulation of economic growth, the development of underdeveloped areas and providing of incentives to certain categories of the population. The fact that CIT incentives are the most important form of tax incentives in general is also demonstrated by Table I, which shows the various forms of tax incentives employed in the world today. The fact is that the majority of more than hundred existing types of tax incentives are actually CIT incentives, which are equally used both in developing and developed countries.

TABLE I
TYPES OF TAX INCENTIVES EMPLOYED

Tax incentives	Developing countries (52)	Developed countries (51)	Total (103)
Reduced CIT rate	43	40	83
Tax holidays	37	30	67
Accelerated depreciation	26	21	47
Investment allowance	18	8	26
Social security reductions	5	7	12
Import duty exemptions	39	24	63
Other	32	13	45

Source: Easson (2004)

An important issue for their implementation is how effective tax incentives really are in stimulating economic activity (economic growth, investments and export). According to the mainstream opinion in economic science, tax incentives play no crucial role in investment decisions, and their role is in fact just slightly more significant with respect to the choice of investment location (country), whereas they hardly have any effect at all on the initial investment decision

[15], [5]. However, the role of tax systems has changed throughout history and consequently some recent studies suggest an increasingly significant role of the tax system in this respect [3], [12], [10], [1]. The reason for this lies precisely in the fact that in the globalization era countries are becoming increasingly similar as investment locations, especially within regional economic integrations such as the EU, where processes of harmonization and coordination of economic policies are more intensive. The more similar the countries are, the more they represent potential substitutes for one another as investment locations, and it is in such circumstances that tax incentives play an increasingly significant role in stimulating competitiveness and economic activity [11].

Similar conditions can be assumed for other Western Balkan countries. They in their own perspective wish to become EU members, and therefore are forced to adapt their tax systems to the conditions of the European single market. The exception here, because of it EU membership, is Slovenia, which in the context of this research paper can prove to illustrate how tax systems of observed countries should appear in the future. On the other hand, Western Balkan countries are undergoing a slower and a more painful transition process than that of the EU-12 countries (war, corruption etc.). As transitional countries they are expected to try and further pool foreign investments and increase economic activity through their tax system.

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III. Tax Incentives in Western Balkans Countries

As mentioned previously, in theory tax incentives group in three categories: reduced tax rates, tax holidays and other investment incentives, while in practice there is a large number of versatile incentives that can encompass the characteristics of different incentives. For the purpose of this research paper we will divide Western Balkan countries' tax incentives into three groups:

1. tax rates,
2. tax holidays, exceptions and similar incentives
3. other investment incentives holding an emphasis on tax allowances, tax credits, accelerated depreciation and tax loss transference

A. *Tax rates*

The efficiency of the CIT rate is quite difficult to determine, since in its on right it represents neither a relief nor an incentive. However, relatively low tax rates can positively affect investments to a much greater extent than any other instrument, and it is precisely due to this that the CIT rate is generally seen as the simplest but also the most effective tax incentive instrument [9]. Reduced or preferential tax rates are the simplest but at the same time also the harshest tax instrument, since the level of incentives does not vary with the level of investment. Furthermore, the efficiency of this instrument is minimal in the case of low marginal tax rates. Preferential tax rates are most commonly employed for companies which are just starting their business, and there can be a distinction between companies from certain sectors and geographical areas [6].

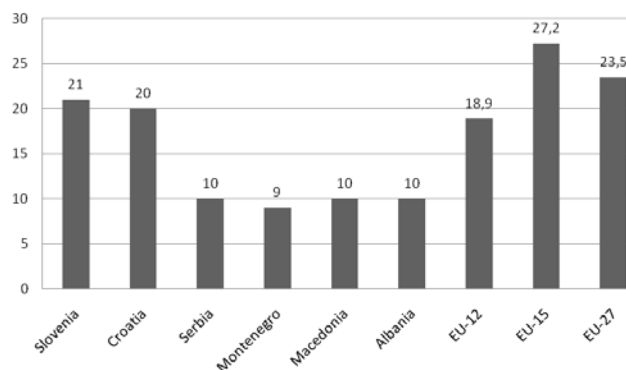

Fig. I Statutory CIT rates (in %)

Source: prepared by authors according to IBFD (2010) & European Communities (2009)

Fig. 1 shows CIT rates applied to the Western Balkans countries and to the EU. According to the figures presented, Croatia and Slovenia have a significantly higher CIT rates with respect to other Western Balkan countries. New EU-12 countries, on the other hand, in average apply a negligible lower CIT rate than Slovenia and Croatia. Regarding that Slovenia is already a member state and Croatia most probably will be the 28th state in near future, the similarity of Croatia, Slovenia and EU-12 is expected. By comparing Serbia, Montenegro, Macedonia and Albania with the EU averages we can conclude that they have substantially lower rates and that they can be observed as tax incentives. Furthermore, it is important to mention that some countries like Macedonia have additional 0% CIT rate on retained profits, while 10% rate is used on distributed profits and non-deductible expenses.

B. *Tax holidays, exemptions and similar incentives*

The efficiency of tax holidays is also difficult to define, since these tax holidays are closely related to reduced CIT rates. Tax holidays can in fact be seen as a milder form of incentive involving the taxation of corporate income at a reduced rate and for a defined period of time.

Relevant literature most commonly sees tax holidays as a relatively ineffective means of investment incentive, primarily due to its selective character which undermines the principle of neutrality of the tax system. Its deficiencies are additionally seen in the loss of tax revenues, and the preferential treatment of short-term investment as a result of their limited duration. In fact, as it was the case in many countries of Central and Eastern Europe numerous investors were not able to fully exploit tax holidays due to the long-term character of their investments [7]. On the other hand, tax holidays are considered to be a simple instrument, which, for all its deficiencies, is, able to mark a certain country as receptive to foreign investment [2]. Due mostly to the above mentioned deficiencies, this type of incentive has been abolished in many

developing countries, but has still been retained in combination with other tax incentives [10], [16].

Disregarding the relative inefficiency of tax holidays, they, among the observed incentives, are most commonly used in Western Balkan countries in combination with other incentives. Table II shows tax holidays, exceptions and other similar incentives in the Western Balkan countries.

TABLE II
TAX HOLIDAYS, EXEMPTIONS AND SIMILAR INCENTIVES

Country	Type of tax holiday, exemptions or similar incentive
SLOVENIA	*Special economic zones*: Preferential tax treatment is guaranteed until 2010 to companies operating in the Koper and Maribor Economic Zones. The benefits include reduced corporate income tax rate (minimum rate 10%) on income derived from activities carried out in the zone. *Tonnage tax*: Qualifying taxpayers instead of paying CIT under general rules, may opt to pay a tonnage tax insofar as they render international maritime services using vessels of more than 100 gross tones each. The taxable base is calculated by multiplying the daily rate, which is established by reference to the net tonnage of a vessel, by the number of service days of the vessel. The tax is calculated on such taxable base at the general rate. Once a taxpayer has opted for the tonnage tax scheme, it commits itself to the scheme for a period of 10 years.
CROATIA	*Tax holidays for investments*: Such tax holidays are allowed for 10-year periods during which a reduced tax rate (10%, 7%, 3%) or a full tax exemption (0%) is applied, depending on the investment amount and the number of new employees. The stipulated conditions must be met within 3 years from the beginning of investment *City of Vukovar*: Full exemption until Croatia enters EU. Tax payers have obligation to permanently employ at least 5 domicile employees. *Areas of special national concern:* Taxpayers engaged in agriculture and fishery may be fully exempt from profits tax (0%) or may be taxable at a reduced rate (5%, 15%, 17%). Reduced rate depends on whether the area is classified as an area of first, second or third category. This incentive applies until 2016 for the first category areas and 2013 for the second and third category area. Their zoning mostly depends on war destructions and development. Taxpayers have obligation to employ at least 5 domicile employees. *Hill and mountain areas*: Taxpayers are subject to a reduced profits tax rate (15%). Their obligation was to employ more than 5 domicile employees. This incentive is in force until 2010. *Free zones:* First variant permits exemption (0%), up to the upper allowed limit of incentive if there is investment in buildings of more than 1 million HRK. Second variant of incentive is engaged in business activity in free zones in the 3 regions: Northwest Croatia (till 2010 rate is 10%, 2011-2013 rate is15%), Central & East Croatia and Adriatic Croatia (till 2013 rate is 10%, 2014-2016 rate is 15%), and City of Vukovar (till 2010 exemption, 2011-2013 rate is 5%, 2014-2016 rate is 15%).
SERBIA	*Corporate tax holidays:* Enterprises are exempt from CIT for 10 years, starting from the first year in which they realize taxable income, if they invest in fixed assets an amount exceeding RSD 600 million and during the investment period they employ at least 100 additional employees for an indefinite period. The proportion of tax exemption is set as the ratio between investment in fixed assets and the total fixed assets which include assets before investment and invested assets. *Tax holidays for concessions:* Enterprises engaged in activities subject to a concession, e.g. the exploration for or the exploitation of natural resources, may be exempt from corporate income tax for up to 5 years. *Non-profit organizations*: is exempt from corporate income tax, subject to certain conditions for income up to RSD 300,000.
MONTENEGRO	*Tax holidays & other incentives for undeveloped areas:* A 3-year exemption (0%) is granted to newly established production companies in undeveloped areas. Further, companies deriving income through a newly established branch in an undeveloped area are granted a tax credit equal to the proportion of the branch income to the total income. This relief is granted for 3 years. *Non-profit organizations:* Up to EUR 4,000 of the income derived by non-profit organizations is exempt from corporate income tax, subject to certain conditions.
MACEDONIA	*Previous incentives:* The previous incentive legislation has been repealed, but taxpayers who qualified for the incentives may continue to benefit from them. *Micro-enterprises*: one is qualified as a micro-enterprise if its total income does not exceed EUR 50,000 and it is engaged in economic activities other than banking, financial, insurance, entertainment and gambling. They pay an annual tax on the total income instead of the profit tax. Prior approval from the tax administration must be obtained. The annual tax liability is calculated in the amount of 1% of the total income realized in the previous calendar year. *Free zones:* A company that is a user of a technological industrial development zone is exempt from profit tax for a period of 10 years from the day of commencement of its activities in the zone if specific conditions are met and subject to prior approval by the tax authorities.
ALBANIA	*Previous incentives:* The previous incentive legislation has been repealed, but taxpayers who qualified for the incentives may continue to benefit from them.

Source: prepared by authors according to IBFD (2010)

Besides the dominant role of tax holidays, most of the observed countries use them in the purpose of encouraging special (economic, free) zones and also underdeveloped areas. Slovenia has abandoned this practice while Croatia still has regional tax holidays that are applied in underdeveloped geographical areas and areas that have been struck by war. Croatia, being on the EU's doorstep, is slowly abandoning the idea of regional tax holidays. On the other hand, Serbia and Montenegro do not share the same intent.

Investment incentives in special zones were easily justified in the earlier years, when those countries were relatively underdeveloped market economies, but now, however, they are more developed and share common markets. The purpose of those zones was to pool highly mobile activities rather than capitally intensive long term activities which in conclusion lead to attracting capital from other parts of the country, and not so much from foreign direct investments. On the other hand, tax incentives for undeveloped regions are in harmony with the regional development policies that have a purpose of compensating for the inadequacies of said areas and their

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development, and are also accepted by the EU.

Albania and Macedonia have accepted a different method of encouraging economic activities through their tax systems. Their use of tax holidays is practically next to nothing, and if they are ever used, they are very limited. Considering that the aforementioned countries have relatively low tax rates, they have turned to the strategy of building as simple as possible tax system, one that would have the least amount of tax benefits which in turn ruin the efficiency and simplicity of the CIT. The extreme example of such a system is the flat tax system.

C. Other investment incentives

Other investment incentives in the broader sense are given more preference with regards to efficiency, whether it be accelerated depreciation or certain other types of investment allowances. Such types of incentives can namely be much more easily directed towards particular types of investments, and can be connected to the level of investment. On the other hand, such incentives are generally more complex and require higher administrative costs. This is also the reason why they tend to be used less frequently than reduced tax rates and tax holidays both in developing as well as in developed countries [3].

The main reasons which had a negative effect on the inflow of foreign direct investments in this territory in the early development stages of the transitional countries' tax systems was inadequate depreciation schemes that were too complex and containing insufficient depreciation rates [13]. The improvement of the depreciation scheme is best affected by using accelerated depreciation and various deductions from the base and tax credits.

TABLE III
TAX ALLOWANCES, TAX CREDITS OR SIMILAR INCENTIVES

Country	Type of tax allowances, tax credits or similar incentives
SLOVENIA	*Investment allowance:* equal to 30% of the amount invested in equipment and intangible assets. Annual amount of an allowance may not exceed EUR 30,000 in the year of investment. Any unused amount may be carried forward for 5 tax years. *R&D allowance:* equal to 20% of the amount invested in internal R&D activities or in the purchase of R&D services from third parties. The allowance is limited to the taxable base of the tax year; any excess may be carried forward for 5 tax years. *Specific regions allowance*: Taxpayers established in specific regions may claim reduction of taxable base in the amount of 30% or 40% (varying per region) of the invested amount. *Employment-related reliefs*: equal to 24% of the compulsory retirement and disability insurance contributions of the employees; form 50% to 70% of the gross salaries paid to disabled employees. In the above cases, the deductible amount is limited to the taxable base. *Donations:* generally not deductible for corporate income tax purposes, but contributions in kind for charitable, scientific, educational and similar purposes may be deducted up to 0.3% or 0.2% of the taxable income of the tax year.
CROATIA	*R&D allowances:* Justifiable costs of R&D allow for additional deductions from the tax base by 100%, 125% or 150% of the cost amount, depending on character of the research. *Education and training costs for employees*: up to max. 100% of costs of employee education and training. The level of the deduction (25%, 35%, 50%, 70%, and 100%) depends on whether the company concerned is a small or large enterprise, a company involved in maritime transport, meets the requirements for regional state aid, or other.
SERBIA	*Tax credits*: 20% for investment in fixed assets (except cars, furniture, carpets and art objects), 40% for small companies. The credit may not exceed 50% (70% for small companies) of the tax due. Any excess may, however, be carried forward for 10 years. The newly acquired assets must remain in the possession of the taxpayer for 3 years. 80% of the investment for agriculture, fishing, textile industry, basic or general metal industry, the production of machines, communication equipment, medical equipment, vehicles, recycling activities or cinematographic production; there is no limitation in respect of the tax liability. *Tax credit for new & disabled employment:* A 2-year tax reduction, amounting to 100% of gross salaries and related employee contributions, is available for the employment of new workers, providing that their number is not reduced during this period. Tax credit is granted for employment of disabled persons; the credit is equal to the proportion of disabled employees to the total number of employees. *Underdeveloped areas:* Companies deriving income through a newly established branch in an undeveloped area are granted a tax credit equal to the proportion of the branch income to the total income. This relief is granted for 2 years.
MONTENEGRO	No specific deduction which could be characterized as incentive.
MACEDONIA	No specific deduction which could be characterized as incentive.
ALBANIA	No specific deduction which could be characterized as incentive.

Source: prepared by authors according to IBFD (2010)

Disregarding higher efficiency of other incentives, it cannot be said that they are mostly used in the Western Balkan countries. Tables III and IV show tax allowances and tax credits, with reference to accelerated depreciation and tax loss relief in the aforementioned countries.

Out of all other mentioned incentives, mostly used are the allowances and/or tax credits for investments, research and development and incentives for education and training of employees which is in accordance with world trends. Afore mentioned incentives are broadly implemented in the leading regional countries, of Slovenia and Croatia, what is similar to tax holidays, with Serbia as the only one that follows their trend. On the other hand Montenegro, Albania and Macedonia do not use tax allowances and tax credits. A problem connected to tax credits that may arise relates to deductions from the base which in the end can't be used if the tax base is too small.

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TABLE IV
ACCELERATED DEPRECIATION & TAX LOSS RELIEF

Country	Accelerated depreciation & method	Tax loss relief
SLOVENIA	No (linear method)	Losses may be carried forward indefinitely to be set off in the order in which they were incurred
CROATIA	Allows for the depreciation rate to be doubled (linear method)	Losses may be carried forward for 5 years
SERBIA	Accelerated depreciation is allowed with respect to assets used for environmental protection, scientific research and education, as well as for computer equipment. Depreciation is calculated by applying the prescribed rates increased by up to 25%. (Except for immovable assets (linear), declining-balance method is used for other depreciation groups)	The tax loss stated in the tax return can be carried forward and offset against future profits over a period up to 10 years.
MONTENEGRO	No (Except for immovable assets (linear), declining-balance method is used for other depreciation groups)	Losses may be carried forward for 5 years
MACEDONIA	Prior approval of the tax authorities must be obtained if the total of depreciation allowances would exceed by more than 10% the depreciation computed under the linear method. (companies can choose method, linear method is preferred by tax authorities)	No
ALBANIA	No (linear method for building and intangibles, for other assets depreciation is allowed on a pooled basis)	Losses may be carried forward for 3 years. If during the tax year more than 25% of direct or indirect ownership of the share capital or voting rights of the company is transferred, losses may not be carried forward.

Source: prepared by authors according to IBFD (2010)

Except in tax credits and allowances, extra incentives can be made through accelerated depreciation (Croatia, Serbia) or at least the method of declining balance (Serbia, Montenegro). Taking into account that depreciation schemes are in concordance with the international standards of accounting, accelerated depreciation is the least used method when comparing with other observed incentives. In the occurrence of it being used, more often it is connected with more productive investments such as those for research and development, education, developed high technologies etc.

As far as tax loss relief goes, most of the countries with the exception for Macedonia, allow this method. In general, Western Balkan countries are always in the wake of the current more developed countries' trends, except for Slovenia and less likely Serbia that offers ten year loss transference in advance. The region average is around 5 years, which is well below that of the developed countries. Macedonia should consider implementation of these benefits, while other countries should increase their limit to at least ten years.

IV. CONCLUSION

Western Balkan countries globally implement a relatively large number of CIT incentives. In accordance with the worldwide practice, the predominant form of CIT incentives are tax holidays, but in some countries other types of incentives also play a significant role. The domination trend of tax holidays is utterly logical, considering that the observed countries are transitional and are trying to encourage economic growth and development. The large emphasis here is on attracting foreign capital and investments, which carries market and business behavior norms and prepare the economy for the entrance in the EU.

If we mark the use of tax holidays as an exception, there is not much in common to the observed countries, which, in turn, undermines the validity of a commonly used term "Western Balkans" when trying to depict a set of economic characteristics for said countries. The structure and number of incentives in individual countries are largely defined through a degree of development and achievement in becoming an EU member. Slovenia and Croatia, as the leading regional countries, mostly use horizontal incentives, and are gradually leaving selective incentives, emphasizing on key development areas such as research and development, education and employment. Serbia somewhat follows this trend, Montenegro also, however, using a higher dose of selective incentives for underdeveloped areas, but with much lower tax rates. Albania and Macedonia fell behind the most when looking at the number and structure of tax incentives, however, a conclusion can be made that their relatively low tax burden is actualized through extremely low CIT rate and overly simplified CIT system.

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