INVESTMENT INCENTIVE POLICIES TOWARD ATTRACTING FOREIGN DIRECT INVESTMENTS: THE CROATIAN EXPERIENCE

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ABSTRACT

National strategies across the world often emphasise the role of foreign direct investments (FDI) as one of means necessary to increase the overall national competitiveness. The benefits that FDI generates are traditionally recognized not only through acquiring capital but also through patents, knowledge, know-how, efficient technologies, management skills and the like. Croatia has continuously placed FDI on the top of the development agenda hoping that their inflow would help raise employment, exports and productivity. According to the EU statistics, Croatia is ranked rather high among 'transition' economies, even in comparison with those that have recently become full members of the EU. However, its impact on the national economy, especially employment, exports and productivity is much less evident than that in other Central and Eastern European countries.

The purpose of this paper is to theoretically and practically discuss the role and importance of investment incentives offered by the national policy-makers in order to attract certain FDI projects. The paper will provide a theoretical overview of various approaches to investment incentives. Using the Croatian experience, the paper will provide an analysis of FDI inflows in Croatia in terms of numbers, investment climate and environment as well as it will delineate reasons, i.e. barriers which prevent Croatia to be more attractive to foreign investors. Particular attention will be given to investment incentive policies promoting FDI in Croatia.

JEL classification: F21, O24

Key words: foreign direct investments, incentives, Law on Incentives, Croatia

1. INTRODUCTION

Foreign direct investments (FDI) start to intensively appear in theoretical and empirical studies after the World War II. The regulation of the International Monetary Fund has provided the development of trade and international finances. All forms of financing have been recorded, from a classic debenture to foreign direct investments. There has been a great growth of international financial course during 1980s and 1990s. The reason can be seen in the development of theory and institutional investors in the USA, the growth of networked world financial markets and globalisation, liberalisation of the financial markets.

The purpose of this paper is to theoretically and practically discuss the role and importance of investment incentives offered by the national policy-makers in order to attract certain FDI projects. After introductory remarkds, the section 2 provides a brief overview of the effects of the DDI for the national economy. The definition of the incentive policies, their role and effects on attracting DSI are discussed in the section 3. The section 4 analysis the FDI in Croatia: statistics, dynamics, structure, investing countries as well as legal and institutional framework that deals with FDI. The paper finishes with concluding remark in section 5 briefly summarizing the key findings of the paper.

2. THE EFFECT OF FOREIGN DIRECT INVESTMENTS

Due to globalization, FDI have a prominent role in the implementation of national competitiveness (e.g. Moran, Graham & Blomström, 2005, Borozan & Barković, 2004). Foreign direct investment recepient countries are usually motivated by the social benefit of the FDI, which is seen through the application of various technologies, knowledge and management skills as well as their effect on the rest of economy. FDI has a positive effect on the foreign trade, the growth, employment and investments into domestic economies. It can improve the quality of man power and human capital through training of new technologies and the processes of production.

According to the International Monetary Fund definition, foreign direct investments can be explained as a situation when a certain non-resident investor comes into possession of 10% or more of resident´s proprietary stock where foreign investor has a majority interest in reaching decisions concerning company management, althought he hasn´t got majority proprietary stock in the company (Ridgeway, 2004).

Foreign direct investments are different from other forms of investments due to its permanent interest for the target company, active involvement of foreign investitors and reaching decisions regarding company management. Foreign direct investments can be divided into two cathegories (Babić, Pufnik and Stučka, 2001: 25):

(i) *greenfieled investments*: foreign direct investments which create new production property and (ii) *brownfield investment*: (mergers/acquistions investments or take over investments), the purchase of pre-existing plants and companies as well as taking control over them in order to improve management efficiency

In order to attract foreign direct investments, investors have to be provided with an environment in which they will be able to conduct their business profitably and without unnecessary risk. The present guiding principles originate from the OEDC Committee on International and Multinational Enterprise's 2001-2002 review of incentives-based competition for FDI (OECD, 2002). The conditions sought by foreign enterprises are equivalent to those that constitute a healthy business environment because foreign investors are responsive to the changes in business environment.

3. THE ROLE AND EFFECT OF INVESTMENT INCENTIVES TO ATTRACT CERTAIN FDI PROJECTS

Foreign direct investments have greater role in the growth of the developing countries. Thereby, it can be concluded that it is getting harder to attract foreign investors and that governments of the developing countries face a hard task of improving elementary economic conditions but they also have to devise other incentives to attract foreign investors into their own country. The policies of attracting foreign investors are motivated by targeted efforts at improving host countries´ environment. Some countries employ low corporate tax rates in order to attract foreign investors. The aim of policies for attracting FDI is to provide the investors with the environment in which they will be able to conduct their business profitably, and some of the important factors considered by investory as they decide on investment location are (OECD, 2003):

- a predictable and non-diskriminatory regulatory environment and an absence of undue administrative impediments to business
- a stable macroeconomic environment, including access to engaging in international trade
- sufficient and accessible resources, including the presence of relevant infrastructure and human capital

In order to meet investors´ expectations and to ensure healthy working environment without greater economic changes, the next steps are necessary (OECD, 2003) :

- safeguarding public sector transparency, including an impartial system of courts and law
- ensuring that rules and their implementation rest on the principle of non-discrimination between foreign and domestic enterprises and are in accordance with international law
- providing the right of free transfer related to an investment and protecting against arbitrary expropriation
- putting in place adequate frameworks for a healthy competitive environment in the domestic business sector
- removing obstacles to international trade
- redress those aspects of the tax system that constitute barriers to FDI
- ensuring that public spending is adequate and relevant

Tax incentives, financial subsidies and regulatory exemptions which aim is to attract foreign investors are no substitute for pursuing the appropriate general policy measures. Those incentives may serve either as a supplement to an already attractive environment for the investment or as a compensation for proven market imperfections. Additional incentives usually consist of relieving of certain fiscal taxes for a defined period of time. The governments usually make various demands related to incentives realisation in order to attract the positive effects of foreign direct investments. Some of these conditions are: setting the minimal amount of investment, transfer of technology, employment and likewise. The importance and the appropriatness of the FDI incentive strategies should be examined in certain periods of time. The transparency and the responsibility of the government at all levels increases the success of these incentives.

Numerous authors have been dealing with theoretical and practical discussion of FDI incentives (e.g. Blomström 2002, Blomström & Kokko, 2003, Gergely, 2003, Barković, 2002).

FDI incentives can be defined as measures designed to influence the size, location or industry of the FDI investment project by affecting its relative cost or by altering the risks attached to it through inducements that are not available to domestic investors. Two cathegories of measures meet this definition:

- rule-based approaches that rely on certain norms, discrimination (according to nationality) of investors to be stipulated by law

• specific approaches that tailor incentives to individual foreign investors.[1]

The rule-based approach represents a relatively straightforward selective application of investment subsidies. On the other hand, specific approaches produce a multitude of different incentives, including fiscal derogations, grants and soft loans, free land, job training, employment and infrastructure subsidies, product enhancement, R&D support, ad hoc exemptions and derogations from regulations.

FDI incentives are divided into three categories: (i) regulatory, (ii) financial and (iii) fiscal incentives, all of which are financed by the authorities in the host area. ***Regulatory incentives*** are policies of attracting foreign enterprises by means of offering them derogations from national or sub national rules and regulation. While authorities may in principle choose to derogate from any regulatory practice, the responsibility in reality is on easing the environmental, social and labor-market related requirements placed on investors. ***Financial incentives*** refer to financial assets to companies for financing foreign direct investments. They are motivated by three considerations. First, a host area may be perceived as being disadvantaged relative to comparable sites elsewhere, e.g. because of the stage development in that area. In this case authorities assist investors by means of policy of leveling the playing field which is construed as a help in infrastructure subsidies (providing physical infrastructure or communication tailored to meet the needs of the investors) and job training subsidies (the education of working force). Second, the costs that enterprises incur when relocating, or establishing new subsidiaries at a distance from previous sites, may hold them back from choosing the most suitable locations. Because of this, host authorities offer a subsidy toward meeting the relocation costs by means of: relocation and expatriation support (authorities may offer grants to help meet enterprises' additional capital spending and concrete relocation costs); administrative assistance (it includes preferential treatment by regulatory authorities whereby administrative impediments – such as for example the speed of obtaining permissions – are eased) and temporary wage subsidies (the start-up phase can be supported through the temporary coverage of part of the new corporate unit's wage bill). Third, a policy of targeted incentives is used as a supplement with the first two incentives by means of: credits to investors (authorities grant soft loans or interest subsidies to foreign enterprises for the specific purpose of an investment project; alternatively, they may ease investors financing costs by issuing loan guarantees); real estate (selling land or buildings to foreign investors at below

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1 See more detailed explication on FDI incentives in Blomström & Kokko, 2003.

market values) and cost participation (helping investors cover their start-up costs, help in marketing and developing costs). ***Fiscal incentives*** are most commonly used by the governments of the developing countries in order to motivate foreign investors to invest into their country. These are some of the numerous FDI fiscal incentives. First, reduced direct corporate taxation. These measures aimed at easing the corporate tax burden are used to attract foreign direct investors. Those measures include: reduced rates of corporate income tax (creating investment environment by lowering of corporate tax rates), tax holidays ("newly-established firms"are not required to pay corporate income tax for a specified time period) and special tax-privileged zones (the creation of areas with low rates of corporate taxation amount to fiscal FDI incentives in the cases where foreign-owned enterprises enjoy privileged access to operate in such zones). Second, incentives for capital formation. Lower taxation to corporate investment used as a method of attracting FDI and providing them with incentives to invest. The examples include: special investment allowances (firms are provided with faster write-offs for qualifying capital costs by means of accelerated depreciation or enhanced deductions), investment tax credits (such tax credits are earned as a percentage of qualifying expenditures and offset against taxes otherwise payable) and reinvested profits (offering deductions or tax credits against profits that are reinvested in the host economy). Third, reduced impediments to cross-border operation. Companies are attracted to locations where the fiscal system imposes minimal costs on the crossborder transfer of funds, goods and services and manpower. Some of the incentives on offer are: withholding tax (reduced rates of withholding tax on foreign-owned enterprises remittances to their home countries), taxation of foreign trade (reduced import taxes and customs duties) and taxation of employees (lower personal income tax or social security reductions for expatriate executives and employees). Fourth, other tax reductions. The selective lowering of any tax rate affecting the enterprise sector may be used to attract foreign enterprises.

4. FOREIGN DEIRECT INTVESTMENTS IN CROATIA

4.1. Brief analysis of FDI in Croatia

Globalization in world economy today brings great structural changes which have a strong effect on small economies like Croatian. So, it is important to turn every change into benefit and progress. Croatian economy has to be open in order to stimulate domestic growth and development. Here, foreign direct investments play a great role. In the short-run, Croatia, with the help of foreign direct investments, can acquire new knowledge regarding business in market enterprises, the organization and management of business units. Foreign investments lead to knowledge of business in market system as well as contribute the rise of competition (for example, telecommunications and banking) which ensures more effective business of domestic companies as well as the introduction of new technologies and better restructuring of the domestic economy.

The analysis of direct investments is an important issue because foreign investments have a significant role in attracting further investments. Between 1993 and third quarter of 2009, FDI accumulated to 23,6 milliard EUR (table 1). In this amount, 13.7 milliard EUR refers to equity investments (around 58% of the total FDI amount), 6 milliard EUR refers to other investments (26%) and 3.9 milliard EUR (16%) of a retained profit. The greatest inflow of exchange reserves in the form of equity investments happenned in 2007, in the amount of 2.2 milliard EUR by the financial mediation (banking). In 2009, foreign direct investments according to first three quartals amount to approximately 1,7 milliard EUR (about 7,2% of the total FDI) which represents the growth in 786,2 million EUR[2] in comparison with the first six months. The greatest contribution to the foreign investment growth came from the growth of investments in wholesale and commerce mediation. From the first quarter with only 12,8 million, it raised to 707,5 million EUR and financial mediation, apart from insurance and pension funds (banking) in the amount of 677,5 million EUR[3].

Table 1. Foreign direct investments in the Republic of Croatia (in mil EUR)

	Equity investments		Reinvested earnings**	Other capital		Total
	Claims	Liabilities		Claims	Liabilities	
1993	0,0	101,0	n/a	n/a	n/a	101,0
1994	0,0	92,8	n/a	n/a	n/a	92,8
1995	0,0	79,1	n/a	n/a	n/a	79,1
1996	0,0	382,1	n/a	n/a	n/a	382,1
1997	0,0	325,0	35,9	-7,1	126,4	480,2
1998	0,0	581,1	63,9	-12,8	217,6	849,7
1999	0,0	1.208,6	43,4	-0,2	111,1	1.362,9

2 Source of data: http://www.vecernji.hr/biznis/izravna-inozemna-ulaganja-kraju-treceg-tromjesecja-1-7-milijardi-eura-clanak-78207 (28-02-2010)

3 Source of data: http://www.liderpress.hr/Default.aspx?sid=93802 (29-02-2010)

2000	0,0	750,6	86,8	0,7	302,5	1.140,6
2001	0,0	910,8	187,9	0,2	368,7	1.467,5
2002	0,0	718,3	160,9	-0,3	259,0	1.137,9
2003	0,0	762,0	587,9	-1,5	414,0	1.762,4
2004	-0,2	319,9	291,7	-17,8	356,0	949,6
2005	0,0	793,0	570,5	0,0	104,4	1.467,9
2006	-0,1	1.743,5	717,5	16,6	287,3	2.764,8
2007	0,0	2.202,4	483,3	-2,7	987,2	3.670,2
2008	0,0	2.173,9	508,5	-26,3	1.534,1	4.190,2
2009Q1,Q2,Q3	0,0	559,7	147,7	-4,3	996,1	1.699,2
TOTAL	-0,3	13.703,9	3.886,0	-55,6	6.064,2	23.598,1

Source: Croatian Central Bank, http://www.hnb.hr/statistika/hstatistika.htm (13.02.2010)

By investigating the foreign direct investments structure, 559, 7 million EUR referred to equity investments. At the level of whole 2009, FDI will certainly be less than in 2008 due to fear from risky markets. This year, with the recovery of the euro zone economy, the growth of foreign investor's interest for Croatia can be expected. The size of interest will depend on structural reform pursuit as well as incentives policies and overall improvement of investment environment. The structure of equity investments in Croatian economy relates to several activities: 46, 5% of overall investment relates to financial mediation except from insurance and pension funds (banking), wholesale and mediation. The other direct investments refer to chemical production (6,8%), the production of coke, oil derivatives and nuclear fuel (6,1%), post-office and telecommunications (5,4%), real estate business (5,2%), retail sale (4,5%), oil and natural gas extraction (3,7%), the production of other nonmaterial mineral products (3,7%), hotels and restaurants (2,6%) and the rest of activities (15%). In the period from the first foreign capital influx to the third quarter of 2009, the greatest foreign investments in Croatia came from EU countries. Austria invested the most with 6,3 milliard EUR or 27% of all foreign direct investments, the Netherlands with 4,1 millard EUR or 17% of all foreign direct investments and Germany with 2,7 milliard EUR or 11% of all foreign direct investments. By investigating transitional countries, the most foreign direct investments came from Hungary with 2,1 milliard EUR or 9% of all foreign direct investments and Slovenia with 1 million Eur or 4% of all foreign direct investments (Croatian Central Bank, 2010). Most of foreign investments was in financial mediation (banking), wholesale and telecommunications, while in the previous year came to the growth of investment in wholesale and commerce mediation. Picture 2 presents graphic display of foreign direct investments from 1993 to the third quarter of 2009 and the relation of Croatia with the transitional countries in 2008. It can be seen there that Poland attracted the most foreign investments for 2008 with the amount of 11 milliard EUR. Croatia is shoulder to shoulder with Hungary with 4,1 milliard EUR of foreign direct investments for Croatia and 4,5 milliard EUR for Hungary. Slovenia was the worst with 1,2 milliard EUR.

4.2. Legal and institutional framework for FDI in Croatia

Promotion of foreign direct investments in Croatia is arranged by the Law on Incentives that entered into force in July 2000 (National Gazette, no. 73/2000). It refers to investment incentives of domestic and foreign, legal and natural persons with the aim od reaching economical growth and stronger competitiveness.

Incentive measures in Croatia are related to fiscal incentives and consist of tax and custom privileges and they are defined by the law on incentive investments. foreign direct investments are encouraged into economic activities if that is the way to ensure ecologicaly accepted activity and one or more of the stated goals: the introduction of new technology, new production procedures, higher employment and employee training, modernisation and improvement of business, the development of production with the higher degree of processing, the rise of export and economic activities in the parts of Croatia where the economic growth and employment are under state average, the development of new ways of services, energy savings, improving information technology, cooperation with financial institutions outside country, the adaptation of Croatian economy to European standards (Bilas, 2006). Incentive measures represent sale or giving to use of real estates or other infrastructure objects under commercial or favoured conditions for the opening of new workplaces and as a help in specialized training or prequalification.

The *Agency for Promotion Trade and Investments* (abbreviation in Croatia: APIU) was founded in 2003. Its most important task is to help investors in realization of investment projects, offering measures for the improvement of investment environment and presentation of Croatia abroad as an attractive investment location, the creation of positive investment environment, unifying resource data that are used by investors, the organization of investors visits to potential investing locations, realization of investment projects and providing with postinvestment services, recommendation of improving legal regulations to stimulate further investments and to support Croatian exporters (APIU, 2010). The results of the Agency's work are noticed during 2006. In the first six months, Trade and Investment Promotion Agency assisted in initiation of nine investment projects which overall value exceeds 260 million EUR.

5. CONCLUDING REMARKS

Croatia is a small country in comparison with other European countries which imposed itself as one of the stronger and more developed market economies in the south east Europe. It has got a medium consumer strength according to GDP per capita, stable rate of GDP growth, low inflation rate, stable exchange rate and a high rate or unemployment. In order to increase the level of competition, global trends and strategies of attracting FDI should be followed. Croatia is in the fourth place among transitional countries according to attracted foreign capital per capita. But, a disturbing fact is that two thirds of foreign capital is invested into banking, telecommunication and trade. There are little greenfield investments and production investments and in this part, Croatia is one of the weakest among transitional countries. And this is of key importance for economic growth. In order to attract foreign direct investments, it is necessary to use our advantages (natural resources) and to fortify additional incentives along with already used. Beside those issues, some other long-term chronic issues have to be solved because they create negative climate. Those issues are: high degree of ineffectiveness and corruption, slow administration, slow export growth, rising deficit of extra budgetary funds as well as high foreign debt.

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