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Attracting and Directing Foreign Direct Investments: The Example of Slovakia in EU Enlargement and how Serbia can Benefit from It

by* Semsudin Plojovic, Ph.D.*, University of Novi Pazar
and
Enis Ujkanovic, PMP*, University of Novi Pazar*

Belgrade, July 2010

This policy paper has been prepared with the assistance of the Pontis Foundation and the Centre for Democracy and supported by the Slovak Aid through Slovak-Serbian EU Enlargement Fund. The aim of the fund is to provide direct support for Serbian domestic experts, journalists and researchers from the young generation with the aim of rejuvenating and reviving the sector in its goal of disseminating arguments examining the benefits of EU membership for Serbia. The opinions presented in the paper are of the author exclusively, neither necessarily of the Pontis Foundation nor of those of the Center for Democracy and Slovak Aid.

Table of Contents

EXECUTIVE SUMMARY

Foreign Direct Investments, together with EU accession funds, were one of the main factors behind Slovakia "catching up" with more advanced Central European countries (H, CZ, PL) during EU enlargement. The aim of this paper is to give practical guidelines for economic policy in Serbia for creating good environmental conditions for attracting and directing Foreign Direct Investments (FDIs) based on Slovakia's positive experiences. Guidelines presented in the policy paper are based on research into Slovakia's experiences.

This research was focused on fiscal measures introduced by Slovakia's government in attracting FDI and legislation regarding FDI and hiring policies. The research also covered the reasons and logic behind the measures, as well as conditions necessary for the measures to be a success.

This Policy Paper can be used by government institutions such as the Ministry of Economy & Regional Development, Ministry of Finance, strategy and policy-makers in the field of fiscal policy and local self-governments in Serbia and other countries in the Western Balkans.

About the authors:

Semsudin Plojović, Ph.D. works at the University of Novi Pazar. He got his Ph.D. in economics at University of Skopje by defending the theses „Statistical and econometric models of imports and exports of the Republic of Serbia". He is the author of numerous scientific articles in the field econometrics, information systems etc.

Enis Ujkanović, PMP is an economist with special interest in Project Management and Regional Development. Since 2007 he participated in the series of Capacity Building Programs and trainings for CSOs, NGOs and other organizations in Western Balkans. At the moment he works at The University of Novi Pazar as Assistant for Project Management and Business Statistics.

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1. Introduction

On its path to the EU, Serbia is facing major problems with its budget deficit, high unemployment, low productivity - which is just 42% of the EU average, low growth rate, high trade deficit and an overall uncompetitive economy.

It has been proved that, among the new EU member states, countries with the highest FDIs have been those with the highest growth rates. FDI contributed to lowering unemployment, increasing productivity, increasing exports and creating a competitive economy. Slovakia is a good example. FDIs in Slovakia accounted for much of the growth in the period 2000-2008. FDI inflow in Slovakia cumulatively reached $39.4 billion in 2008[1]. Because of its fast growth Slovakia is now considered the „economic tiger" of the region.

Unemployment in Slovakia peaked at 19.2%[2] in 2001 and fell to 9.6% in 2008[3].

Among the biggest employers in Slovakia are large international companies such as Volkswagen (Bratislava), Peugeot (Trnava), Kia Motors (Žilina), US Steel, Samsung Electronics, Sony and Whirlpool.

In the period 2001 - 2008 the average FDI in Serbia was $2 billion[4] but this did not produce the positive results which had been expected. So, in 2004 the six biggest foreign investors in Serbia (Philip Morris, Lukoil, Holcim, British American Tobacco, Lafarge AG, and Titan) had imports that were 15% larger than exports[5].

Slovakia has managed to direct FDI to areas strategically important for its economy and has constantly lowered its trade deficit so that it was just 2.69%[6] in 2008, compared to 108%[7] in Serbia.

Serbia has competitive advantages similar to Slovakia's when it joined the EU: a relatively cheap and skilled workforce, as well as a good geo-economic position. Slovakia has already

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[1] U.S. Department of State (http://www.state.gov/r/pa/ei/bgn/3430.htm

[2] News of the Month, International Center for Economic Growth, February 2006, page 14.

[3] Slovak Ministry of Finance, http://www.finance.gov.sk

[4] World Investment Report (WIR) 2008.

[5] Mr. Marija Petrović-Ranđelović, Ekonomske teme, br.l7, Niš, 2006., str. 127-136

[6] Slovak Ministry of Finance, http://www.finance.gov.sk

[7] Serbian Ministry of Finance, http://www.mfin.sr.gov.yu/

passed through the transition period and problems that Serbia is now facing. That is why it is very useful to have an insight into Slovakia's experience in attracting FDI and learn how to make best use of it and avoid its possible downsides so as to improve productivity in Serbia and the overall competitiveness of the economy.

2. Terms and methodology

Foreign direct investment (FDI) is investment of foreign capital and know-how into domestic facilities, equipment and organizations. It does not include investments in securities. Foreign direct investments are considered more useful for the country than investments in equity capital because the latter is potentially "hot money" that could leave the country as soon as problems appear, while FDIs are more permanent, whether the situation in the country is good or bad.

Direct investment includes an initial transaction between two entities and all subsequent transactions between them and among branches regardless of whether they are registered as legal entities or not[8].

The research was carried out in two parts. The first part of the research focused on analyzing secondary data and existing publications on the subject of FDI in Slovakia, measures that Slovakia has introduced to attract and direct FDI and its impact. Following analysis of collected secondary data, researchers made a list of information needed to be collected in field research.

The second part of the research was field research. This field research was conducted in Slovakia, and included interviews with researchers at the *University of Economics in Bratislava* and representatives of the *Structural Policy Department* of the *Financial Policy Institute* at the Slovak Ministry of Finance. The field research focused on the reasons behind each measure used to attract and direct FDIs and conditions that influenced its success or failure.

3. What determines FDI?

Decisions about where to invest are generally based on detailed calculations. The nature of this decision process is not thoroughly analyzed, but there have been some surveys among multinational companies that have cast some light on this question.

One thing is clear, and that is that FDIs, in principle, are very heterogeneous. Different motives for investing determine the importance of various investment factors[9].

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[8]
Fifth Edition of the IMF's Balance of Payments Manual (BPM5), http://www.imf.org/external/np/sta/bop/bopman5.htm

[9] Gorg, Holger and Greenaway, David, (2003), "Much Ado About Nothing? Do domestic firms really benefit from foreign direct investment", Discussion Paper, Institute for the Study of Labor, pg. 112

It is clear that different goals, needs and strategies lead companies to use different mechanisms for the evaluation of locations for investment. However, there are certain criteria that consistently appear in research: **access to consumers, a stable social and political environment, ease of operation, reliability and quality of physical infrastructure, ability to hire professionals in the field, ability to hire good managers, corruption, labour costs, crime and safety, rates of corporate tax, price of infrastructure services, etc.**

According to a UNCTAD report from 1998 the determinants of FDI are classified into three clearly separate groups: *a framework of state policies, economic determinants and benefits for business.*

A key determinant for a country's FDI inflow which can be influenced directly by government is the business climate or business environment. The business climate is composed of all government policies that affect business, such as tax policy, trade policy, labour policy, urban planning and building policies etc.

4. Components of the business environment

Since the business climate or environment is the main factor which the government can influence regarding FDI, we need to be clear what the components of the business environment are, and what determines it.

The concept of the business environment is quite vague. There are numerous components of the business environment. One of the best international comparisons when it comes to the business environment is the "Doing Business" series of reports produced every year by the World Bank.

These reports provide information and a comparison of business regulations and their enforcement in 178 countries worldwide. The reports cover ten major areas: Starting a Business, Dealing with Construction Permits, Employing Workers, Registering Property, Getting Credit, Protecting Investors, Paying Taxes, Cross-border trading, Enforcing Contracts and Closing a Business.

5. The current situation in Serbia and recommendations for improvement

The following table shows the comparative assessment of the business environment, on the basis of the Doing Business report for 2010[10]. We will analyse each item and propose improvements.

[10] www.doingbusiness.org

Ease of...	Doing Business 2010 rank		
	Slovak Republic	**Serbia**	**Difference**
Doing Business rank	**42**	**88**	**-46**
Starting a Business	66	73	-7
Dealing with Building Permits	56	174	-118
Employing Workers	81	94	-13
Registering Property	11	105	-94
Getting Credit	15	4	11
Protecting Investors	109	73	36
Paying Taxes	119	136	-17
Cross-border Trading	113	69	44
Enforcing Contracts	61	97	-36
Closing a Business	39	102	-63

Source: http://www.doingbusiness.org/economyrankings/

All these factors (perhaps other than "getting credit" to some extent) are very relevant to foreign investors in making decisions about where to invest.

5.1. Starting a business

In this area, the following specific problems and relevant policy options as solutions were identified:

1. A large number of procedures for starting a business. In Slovakia, the number of procedures is 6, while in Serbia it is 7. The problem is not the number of procedures but their complexity. Serbia has worked on this issue and established a "one stop shop" for all procedures for starting a company at a single location in the Serbian Business Registers Agency. Unfortunately this has not been entirely implemented. The "Guillotine of regulations" has the same goal. The number of procedures should be kept to a minimum to ensure easy registration of business, but also retain security.

2. High cost of starting a business. The cost of starting an enterprise in Serbia is 7.1% of income per capita, while in Slovakia it is just 2%.

5.2. Obtaining permits

In this area, the following specific problems and relevant policy options as solutions were identified:

1. A large number of procedures for obtaining a building permit. In Slovakia, the number of procedures is 13 while in Serbia it is 20. This is not a very big difference but when slow administration and lack of mandatory deadlines are taken into account it becomes clear that the procedure is very complicated and slow. The government can do two things to remove this obstacle: Firstly, reduce the number of procedures and thus speed up the process.

Secondly, a potentially more effective measure is establishing concrete deadlines for administrative bodies for when they must give an answer regarding the building permits, so that investors know exactly how long it will take to get a permit, or at least to get information from the state and/or local authorities.

2. High costs of obtaining building permits. In relation to average income per capita, the cost of obtaining building permits in Serbia is 1,907.5%,while in Slovakia it is just 13.6%. This is a drastic difference. If you are an investor, it is very likely that this figure will give you a negative image of the business climate in Serbia. We have previously seen that there is little difference in the number of procedures, then why is it so expensive to obtain building permits in Serbia? The cost of obtaining a building permit must be reduced or at least its payment must be prolonged in order to stimulate investments. The same measures would have a positive effect not just on FDIs but also on domestic investment which will further improve the overall business climate in Serbia.

5.3. Labour market

In this area, the following specific problems and relevant policy options as solutions were identified:

1. The problem of workforce hiring. It is more difficult to find appropriate workers in Serbia than in Slovakia. This is confirmed by the Difficulty of Hiring Index for Serbia, which is 78, while Slovakia is placed at 17 in the same index[11]. This index refers primarily to the difficulty of hiring workers under a short term contract in Serbia. In Slovakia, a company can employ a worker for a certain time (short or medium term) to work on jobs that are within the core business of the company through a fixed-term contract for up to 36 months. We believe that Serbia, to increase labour market flexibility, should allow workers to be hired for short and medium terms for a company's core business activities and extend the period for fixed-term contracts from 12 to 36 months.

2. High severance pay for layoffs. When a company lays-off a worker who was fully employed in Serbia the company must pay 25.3 weekly wages. Taking into account previous statements this can be seen as an even bigger problem by potential investors. Reducing severance pay would increase workforce mobility and make employment easier.

5.4. Registering Property

In this area, the following specific problems and relevant policy options as solutions were identified:

1. A large number of procedures. Six steps need to be taken to register property once a sales contract is signed in Serbia. In Slovakia it takes only three steps. We believe that this process can be improved by combining the procedure of contract registration, land register registration, the determination of tax and issuing orders for payment. This would simplify the process and an investor could more easily exercise right of ownership, as is the case in Slovakia.

2. Lengthy procedures. Here we meet with repeated problems from the past: a large number of procedures, a long wait for results and therefore a more expensive process. Here

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[11] www.doingbusiness.org

we propose the same solution as in Slovakia: reduce the number of procedures and time needed for these procedures, and lower property registration taxes.

5.5. Loans

In this area, Serbia is in a better position than Slovakia primarily because of the Credit Bureau and The Register of the National Bank of Serbia, where at any moment anyone can see if a company is insolvent and for how long they have been insolvent. This example can be used by other countries in the region but it also shows that Serbia can be a leader in creating a good business environment for investment.

5.6. Investor Protection

In this area, the following specific problem and relevant policy options as solutions were identified:

1. Limited freedom of majority shareholders. In this area of investor protection, "Doing Business" gives Serbia a better rating than Slovakia, but Serbia could follow Slovakia's example in giving greater freedom to majority shareholders, and regulating their responsibilities in more detail.

5.7. Paying taxes

In this area, the following specific problems and relevant policy options as solutions were identified:

1. The complexity of the tax system. The tax system in Serbia is very complex. There are a number of different tax rates, some even change in relation to the tax base (income tax). Slovakia has solved the problem in the following way: There is only one tax rate set at 19%. Slovakia's tax system is primarily focused on indirect taxation and to a very small degree on direct taxation. It is also important to note that in the Slovak tax system there are almost no exceptions, or they are very rare. We believe that the same rule or intention should be present in Serbia's tax system because large numbers of exceptions make the system more complicated and lead to more irregularities and corruption.

2. Double taxation. Serbia has a problem with double taxation, in some cases even triple taxation. Slovakia has solved this problem by abolishing dividend tax and taxes on inheritance, gifts and selling and buying real estate. We think that Serbia should follow this policy in order to improve the business climate and reduce double taxation to a minimum.

5.8. Cross-border trading

Cross-border trading is an obvious example of how certain areas can be regulated when it is in the interest of the state. The situation in Serbia regarding this issue is by all indications (Number of days, number of procedures, cost of transactions…) better than the current situation in Slovakia.

5.9. Protection of private property and enforcing contracts

In this area, the following specific problem and relevant policy options as solutions were identified:

1. A large number of procedures. To enforce a contract in Serbia, 36 procedures must be gone through. The number of procedures is very high and communication and the order in which procedures must be undertaken are very complicated. Here Serbia needs to follow the example of Slovakia and reduce the number of procedures and at the same time simplify the process by allowing some procedures to be performed ex officio.

5.10. The procedures for closing a business

In this area, the following specific problem and relevant policy options as solutions were identified:

1. Cost of closure. In Serbia, the bankruptcy procedure is very simple and easy to implement. It is twice as fast as in Slovakia. However, costs in Serbia are very high. When the investor decides where to invest he also takes into account the possibility that not everything will go as planned and that he might have to close the company. He is then faced with the fact that it will cost him almost one quarter of total company assets. This certainly discourages potential investors from investing in Serbia. It is recommended that the cost of closing a company be lowered. This allows for mobility of resources and for firms to easily move between industries and projects.

6. Conclusion

Commitment to increase Foreign Direct Investment inflow is essential for Serbia. Foreign capital should be encouraged to help reorganize those industries in Serbia that can be competitive in the world market. The best thing the Serbian government can do regarding FDI is to create a good business climate by improving all its components, especially those seen by investors as critical.

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