Rruga Prishtinë–Fushë Kosovë
RKS – 10060 Pristina, Kosovë
Tel: (+381 38) 224 454
Fax: (+381 38) 224 452
www.wbginvestmentclimate.org

The Inventory of Incentives Offered and Awarded in Kosovo

July, 2013

Prepared by:
IFC/World Bank Group
Kosovo Investment Climate Project

Table of Content

DISCLAMER

This report has been prepared by the IFC at the request of the Government of Kosovo in the framework of the Kosovo Investment Climate Project. The Investment Climate Services of the World Bank Group, endeavors, using its best efforts in the time available, to provide high quality services hereunder and have relied on information provided to it by a wide range of other sources. However, it does not make any representations or warranties regarding the completeness or accuracy of the information included in this report, or the results that would be achieved by following its recommendations. This report is not intended to provide the sole basis for decisions by the Government and the Government should make its own independent evaluation of the project and this report should not be viewed as a substitute for such independent evaluation or investigation. The World Bank Group will not be liable for any loss, cost, damage or liability that the Government or any party might suffer or incur in connection with this report.

Introduction

In response to a request from the Government of Kosovo, International Finance Corporation, a member of the World Bank Group, has launched the Kosovo Investment Climate Project. The Project proposes programmatic assistance on the national and municipal levels of government. It provides critical regulatory and investment policy tools to help Kosovo in its European Union (EU) accession process, reduce administrative burden to businesses, and attract FDI.

As part of the initiative, IFC conducted a review of fiscal and non-fiscal investment incentives offered to domestic and foreign investors at the central and local level in Kosovo. The completed inventory is valuable information to Kosovo's authorities in bringing investment incentives to comply with EU principles and align them closer to international best practice.

Objective

The overarching objective of this work is to assist the Kosovo Government in a rationalization of the existing incentive regime. First step toward such a reform is to gather detailed qualitative and quantitative information on the existing incentive regime and to create a complete inventory of incentives. This is the first time that such a detailed work has been undertaken in Kosovo, including selected municipalities/ cities.

Such an inventory of incentives is not only necessary to design and implement a reform program, it also improves the transparency of the regime and can be used as resource for databases and guides. Also, it is essential that incentive data is available to investors in a transparent manner, if the objective of the incentives, namely to attract investments, shall be achieved.

The last section of the report provides preliminary thoughts on the findings and possible reform measures. At this point, the analysis and recommendations are generic and it would need further in-depth research and assessments to develop a well-defined and targeted reform program.

Scope

The inventory includes all types of investment incentives, which are commonly divided in fiscal and non-fiscal incentives. In this context fiscal incentives are defined as "any *tax/customs-related* benefit with the deliberate purpose to influence firms' investment behavior and targeted towards specific firms, groups of firms, or sectors". Non-fiscal incentive is "any measure *not being fiscal* with the deliberate purpose to influence firms' investment behavior and targeted towards specific firms, groups of firms, or sectors"[1].

The inventory covers the two levels of Government in Kosovo: state and **6** municipalities (Prishtina, Ferizaj, Gjilan, Peja, Prizren and Suhareka) out of 37 self-governing units in Kosovo. The respective municipalities/cities were selected according to their high economic activity.

[1] Definition of investment incentives (fiscal and non-fiscal) is in Annex 2

Each level of government has its own policy, objectives, legal framework and practice in awarding incentives to investors. The inventory tries to capture these differences as much as possible.

Data

For each item of the inventory, the following data is captured: fiscal/non-fiscal, objective, type of incentive, government level, year of introduction, eligibility criteria, sector, direct/indirect, discretion, awarding authority, budgeted/awarded amount (2012), number of beneficiaries (2012). The inventory also includes information important for the European Union to assess the offered incentives in the light of the EU State Aid rules. This includes information whether the respective item is targeted toward an economic activity, an economic advantage for the recipient, and a direct or indirect subsidy.

Considering that such an effort has never been made in the country, it is remarkable that most of the data could be collected. This could be achieved between April - July 2013 and only with the support from the involved institutions on all levels of Government. However, some data could not be collected for the time being. Out of **1,219** single entries for the **53** items, **1,142** entries or **94** percent could be completed. In its majority, it is financial data that is missing, e.g. the amount budgeted/awarded in 2012 and how many firms benefited.

Methodology

The data captured in the inventory is based on information provided by the awarding authorities and the review of the legislation. The Government ministries, authorities, councils were approached by mail with a questionnaire[2] requesting detailed information on provided tax and customs reliefs, financial contributions, discounted services, suspended fees and charges from the public funds to private businesses.

The questionnaire was followed up by phone calls, meetings and consultations with officials from the State and the municipalities to validate the data in the inventory, explain the purpose of the survey, give assistance in the qualification of specific items, and ensure timely submission of the filled in questionnaire. In parallel, the legal base for each of the incentive was identified, the text collected, and compared with the provided answers.

Furthermore, private investors and business associations were interviewed to clarify practices and learn the private sector perspective on incentives, award procedures, monitoring and enforcement. The questionnaire worked with a fairly broad definition of the term “incentive” in order to capture any item possibly qualifying as subsidy. All items were at the beginning included in the inventory and later closely examined regarding their qualification as investment incentive. In this exercise, subsidies with pure social, cultural, religious or other non-commercial objective were excluded.[3]

Report

The inventory includes all incentives offered by state at the central level and some incentives offered and awarded by the municipalities in Kosovo. The report begins with a description of the findings included in the inventory. It continues by analyzing the data and

[2] The questionnaire is attached in Annex 4.
[3] The detailed inventory of investment and non-investment incentives in the RS is in the Annex 3 of this report.

putting them into context. Finally, a broad set of recommendations addressing the identified shortcomings of the current regime will be given.

Characteristics of effective incentive regimes

Before analyzing the incentive regime, it is worthwhile to take a step back and see some of the characteristics typically seen in more effective incentive regimes.[4]

The following characteristics are identified in global research as factors that typically improve the effectiveness and efficiency of investment incentives:

Affordable – forgone income or the direct costs of financial incentives should not severely undermine government revenue streams. The Government should calculate and document the cost of direct and indirect incentives to ensure that the costs are affordable.

Transparent – the incentive regime should be transparent for investors and public institutions: investors should have easy access to information on available incentives, qualification and documentation requirements, maximum amounts, the procedure and decision criteria for the award, the length of the procedure, the authority in charge, etc. Relevant public institutions should collect and exchange information on who receives what kind of incentives from whom. A public investment incentive register or any other kind of centralized database could help collecting and distributing information on awarded incentives.

Efficient – apply a streamlined, well-coordinated procedure with one authority responsible to award and monitor the respective incentive. Efficient is a regime that uses the type or category of incentives that achieves the stated objective with the least costs in the shortest amount of time. Efficient is an award process, which does not duplicate efforts, asks only for the necessary documents, coordinates with other involved authorities.

Targeted – targets for incentives should be based on research to confirm that they will benefit the country in ways that would not have been possible if there were no incentives, thereby reducing revenue costs.

Simple – incentive administration should permit easy accessibility and determination of eligibility. The more complex an incentive regime is, the less effective it is. Targeted investors may not know about the offered incentives or do not apply because the process is too lengthy and complicated. Applying investors may spend unnecessarily long time and money to collect reliable information and prepare redundant application documents. Incentives may be duplicated, overlapping, untargeted in a complicated regime. Finally, it might be difficult if not impossible to identify the true costs and impact of an overly complicated regime with numerous involved authorities and players.

Non-discretionary – A regime without discretion and a firm set of award criteria is least discriminatory, limits possibilities for bribes, and increases transparency and accountability, and gives an investor certainty. Consequently, the legal base for an incentive should not give the awarding authority the flexibility to decide upon vaguely formulated decision criteria. Discretion is often supported by a lack of transparency in order to make the decision-maker less accountable.

Positive in its cost-benefit relation – Investment incentives aim to attract additional incentives. But not at all costs. The effort to attract investments makes economically only sense for the State if the costs are more than compensated for by higher benefits from the additional investment. The potential benefits of an investment incentive arise from:

- Higher revenue from possible increased investment.

[4] Annex 1 provides an overview of the types of incentives and the relation between incentives and investment.

- Social benefits – such as jobs, positive externalities, and signaling effects – from this increased investment.

The costs are due to:
- Revenue losses from investments that would have been made even without the incentives.
- Indirect costs such as economic distortions and administrative and leakage costs.

It is difficult to quantify these elements, but trying to do so provide a useful conceptual tool for policy-makers analyzing the general framework for incentives as well as targeted incentives for anchor investments, export-oriented and mobile investments, extractive industries, and so on.

Reviewed periodically – investment incentives should be regularly reviewed to determine their relevance and economic benefit relative to their budgetary and other costs, including long-term impacts on resource allocation.

The Inventory of Incentives in Kosovo

The following provides a quantitative description of the incentives offered in Kosovo.

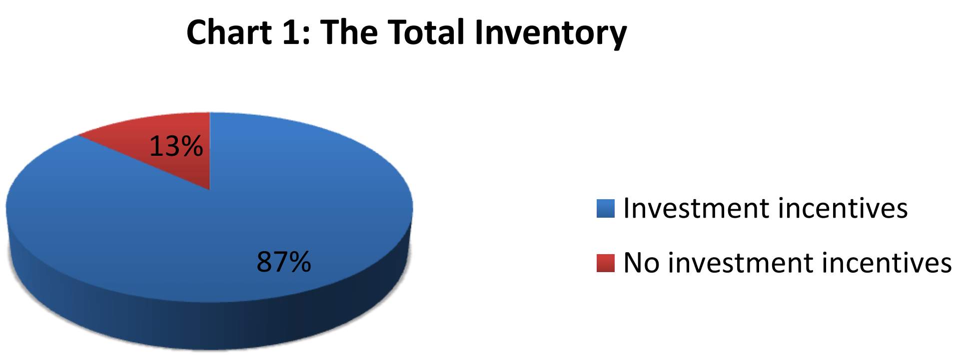
The overall incentives in Kosovo

In order to collect information on all incentives in Kosovo, **16** institutions on both levels of Government were contacted.

The authorities reported in the questionnaires a total of **53** investment incentives. After careful examination, **7** items were eliminated because they did not fit the definition, e.g. because they were awarded to public undertakings or were part of a general relief to all businesses, see **Chart 1**.

The Team applied an inclusive approach to unclear items. The cleaned up inventory includes therefore a total of **46** items that are considered investment incentives under the given definition.

Chart 1: Assessment of all inventory items in Kosovo



All following descriptions of this report will refer only to the **46** items considered as investment incentives.

However, it should be kept in mind that the total inventory covers only **6** municipalities/cities of the **37** units of local self-governance.

Looking at the two government levels awarding incentives, then **89** percent of the total number of incentives are provided on State level and **11** percent of the incentives is awarded by the **6** selected municipalities. This is illustrated in **Chart 3**. **Chart 2** contains the actual numbers of incentives.

Chart 2: Incentives by government level in Kosovo (numbers)

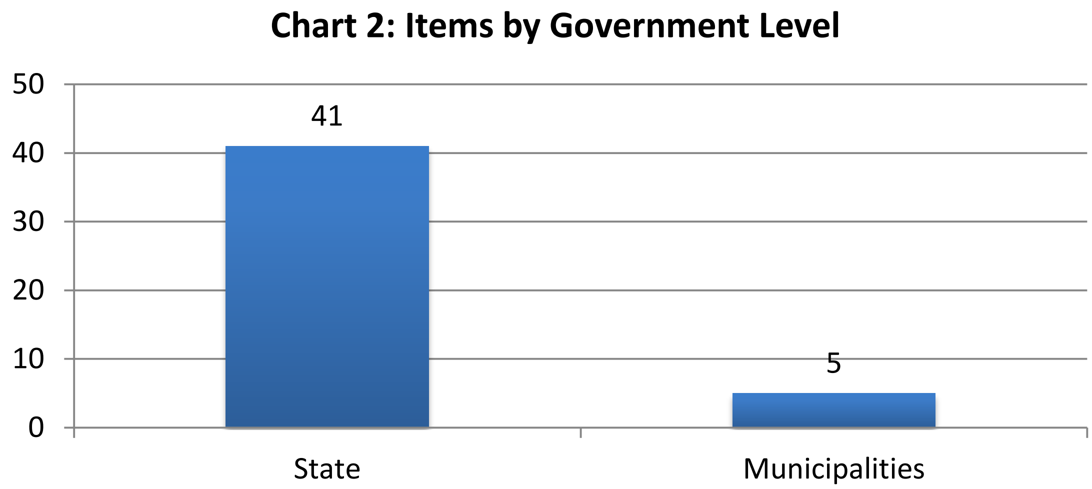
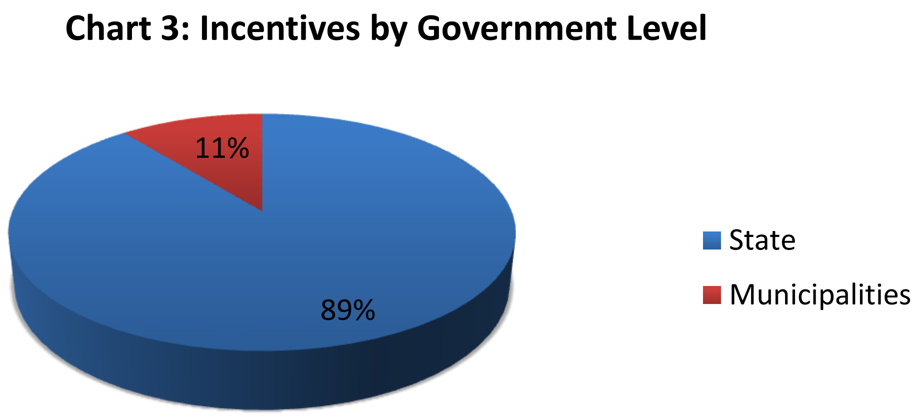


Chart 3: Incentives by government level in Kosovo (percentage)



Awarding public institutions in Kosovo

Out of the **16** contacted institutions in Kosovo, **7** were on the municipal level (city governments). **Table 1** provides a list of institutions that provided information on incentives.

Table 1: Institutions in Kosovo that provided information on incentives

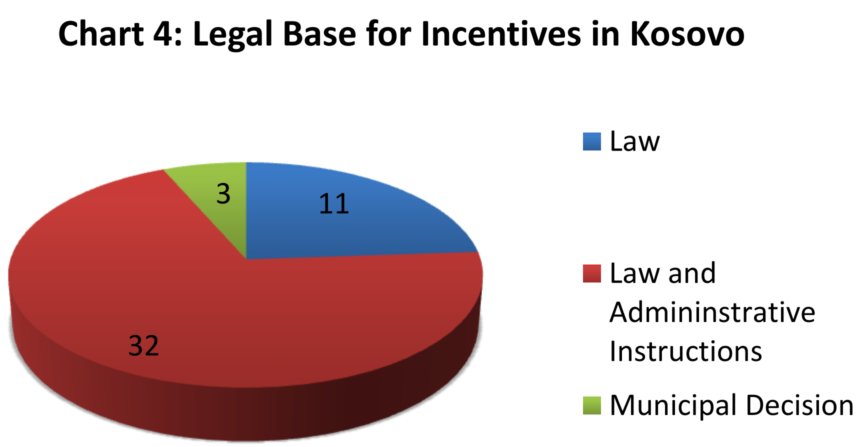
1.	Ministry of Finance
2.	Tax Administration of Kosovo
3.	Kosovo Customs
4.	Ministry of Trade and Industry
5.	Ministry of Agriculture
6.	Ministry of Economic Development
7.	Ministry of Labor and Social Welfare
8.	Independent Commission for Mines and Minerals
9.	Ministry of Education, Science, and Technology (did not provide info)
10.	Municipality of Ferizaj
11.	Municipality of Gjilan
12.	Municipality of Prizren
13.	Municipality of Prishtina
14.	Municipality of Gjakova
15.	Municipality of Suhareka
16.	Municipality of Peja

Legal base

An identification of the legal base is important for a future reform approach. It also gives information on the transparency of the respective incentives, because laws and regulations must be published, while administrative provisions or agreements not.

Almost all incentives in Kosovo are based on primary or secondary legislation. **43** of the **46** incentives awarded in Kosovo are directly based on parliamentary law. **3** of the incentives in Kosovo are based on a Mayor's decision or a decision of the municipal assembly. None of the incentives are based on a bilateral agreement or contract.

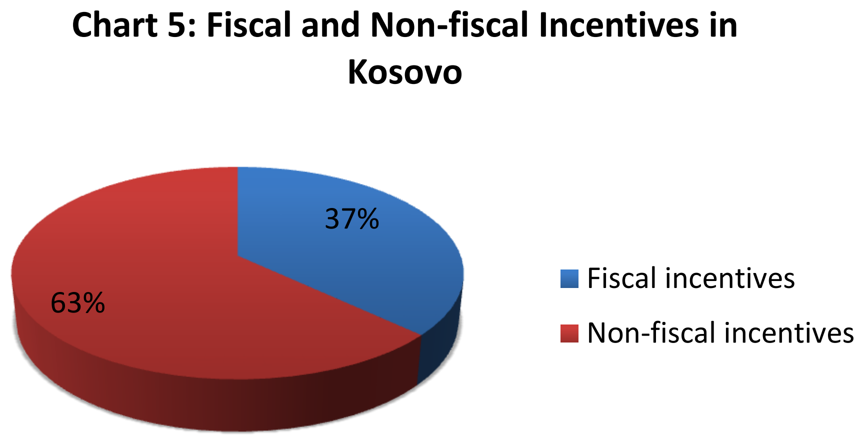
Chart 4: The legal base of awarded incentives in Kosovo



Categories of incentives

Incentives are broadly categorized in fiscal and non-fiscal incentives. Fiscal incentives provide tax and customs duty concessions, while non-fiscal incentives are any other form of state support to investors.[5] In Kosovo, the relation between fiscal and non-fiscal incentives is **17 to 29** items and shows a clear preference for non-fiscal incentives; see **Chart 5**. However, if the 22 agriculture incentives are considered as one incentive given out to various agriculture products, then the ratio would be close to 1 to 1.

Chart 5: The relation of fiscal to non-fiscal incentives in Kosovo

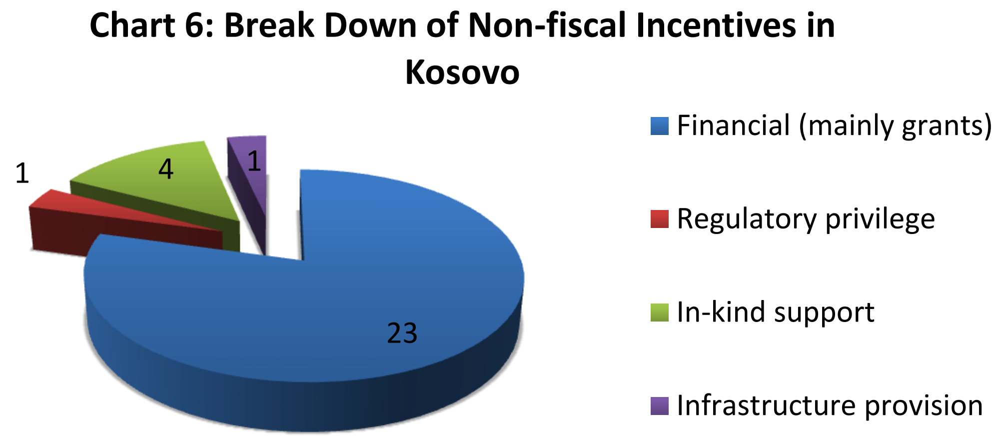


All **17** fiscal incentives in Kosovo are awarded on **state** level. **7** of them are tax exemptions or reductions and **10** are customs duty exemptions. The municipalities offer only non-fiscal incentives. This is explained by the limited possibilities for municipalities to give fiscal concessions.

Breaking down the non-fiscal incentives in Kosovo into its various types (i.e. advisory, financial, regulatory, infrastructure), then it shows that a strong preference lies on financial support. **23** of the **29** non-fiscal incentives in Kosovo are of financial nature and all of them are given out as grants except 1 is a reduced public fee. The remaining non-fiscal incentives are **1** regulatory privilege, **4** in-kind contributions in form of land and services, and **1** provision of infrastructure, as shown in **Chart 6**.

[5] Definition of incentives (fiscal and non-fiscal) is in the Annex 2

Chart 6: Break down of financial support in Kosovo



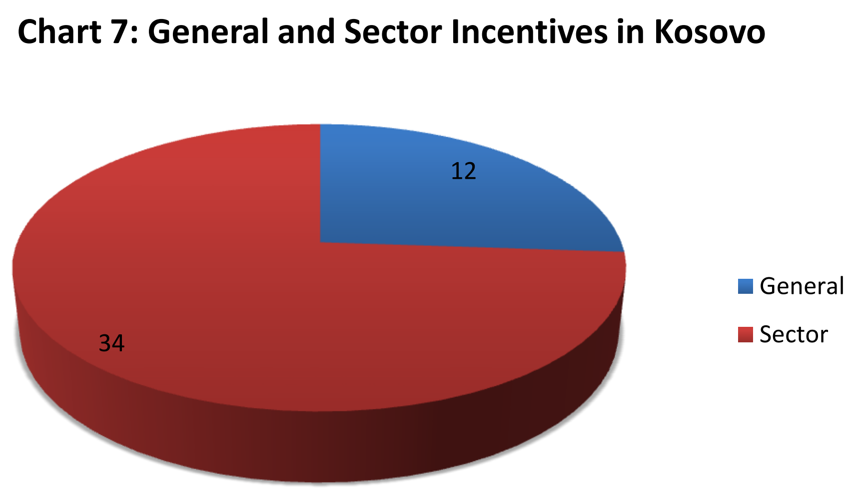
The municipalities offer only non-fiscal incentives: **2** financial subsidies, **2** incentives are in-kind contributions (land/services) and **1** regulatory privilege.

Sectors

A break up of sector preferences is necessary to learn whether the incentives are general or reflect any specific sector policy.

Therefore, the items were filtered for any sector restriction. Of the **46** items in Kosovo, **34** have a sector focus or focus on specific groups of enterprises like foreign investors or SMEs. The remaining **12** items are generally available in all sectors and to all qualifying businesses; see **Chart 7**.

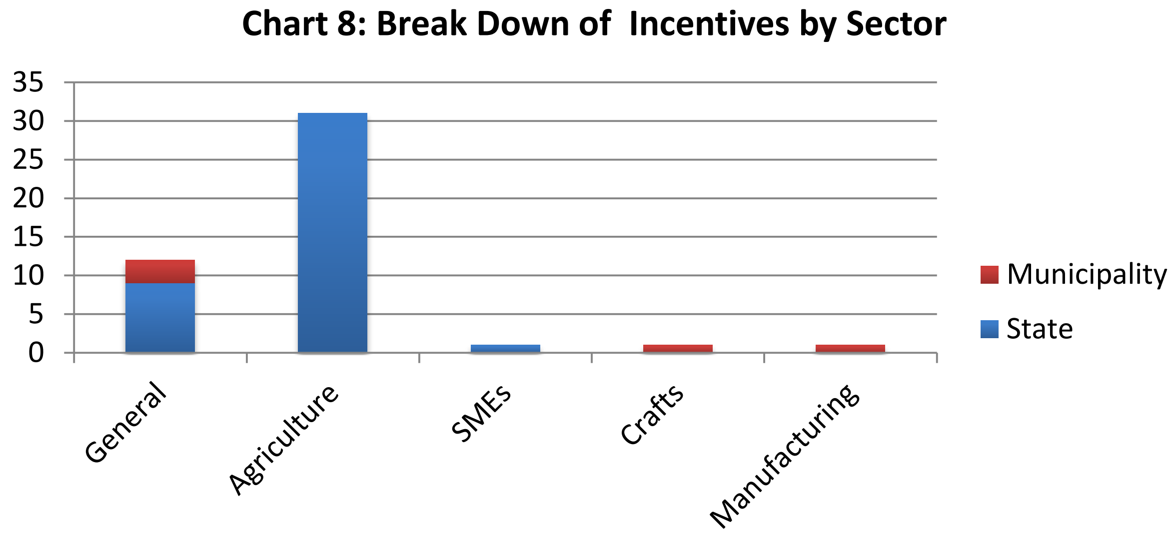
Chart 7: General and sector incentives of overall inventory in Kosovo



Looking closer at the sector incentives, then it shows that the majority of the items is offered in the agriculture sector (**31**), the remaining sector incentives are for SMEs, traditional crafts

(**1**) and manufacturing (**1**). All agriculture incentives are awarded by the State, see **Chart 8**. The municipalities award incentives for all businesses or for crafts and manufacturing.

Chart 9: Sector focus of incentives in Kosovo



In this context, it is important that **3** incentives are geographically limited to Industrial Parks. 1 of the **41** state incentives and **2** of the **5** municipal incentives are only available in designated bonded warehouses or Industrial Parks.

Award procedures

Examining the award procedures allows determining their efficiency and possible reform initiatives. Elements to determine the efficiency of the procedures are its length and the fact if the award is based on a non-discretionary decision. Another element of a good procedure is its transparency, namely the availability of procedural reliable information. Regarding the time and costs of each procedure, a more complex Standard Cost Model Survey would be necessary to provide an objective assessment of the situation in Kosovo.

One important factor for the attractiveness of incentives is whether they are awarded in a transparent manner. A good procedure provides reliable information on its requirements and decision criteria publicly. According to the survey, only 1 incentive procedure does not provide requirements and award criteria publicly beyond the information given in the legislation. Information on all other items is either available in a brochure (**1**) or on a website (**45**). However, after examining the respective website, it became clear that the information is often only a download of the legal base and not a user-friendly presentation of key information on the procedure. In case a website exists, additional information sources such as an information desk officer or leaflets are provided for **39** items.

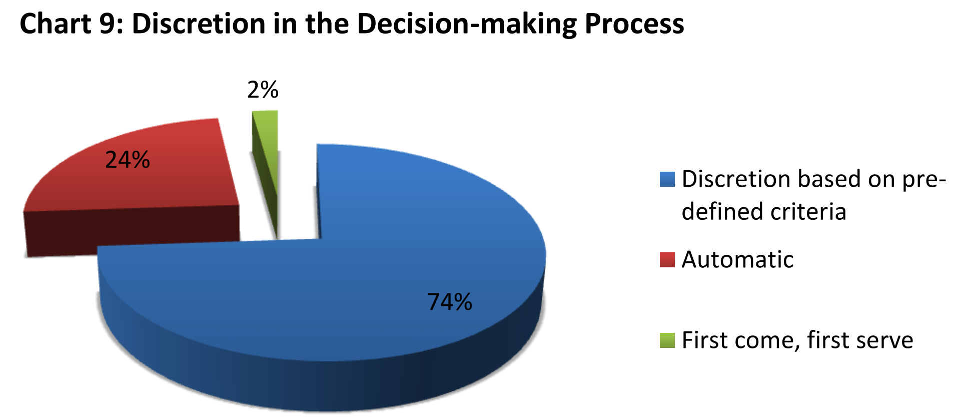
Another important element of a good procedure is an objective process. An incentive decision is either automatic, e.g. based on a stipulated minimum investment, or discretionary, e.g. the decider has the power of free decision or latitude of choice within certain legal bounds.[6] The purpose of discretion is to allow a just decision by taking into

[6] See Definition "discretion" in Merriam-Webster, Legal Dictionary.

account the specifics of an individual case under the assumption that every case is different. However, discretion in a process comes with a down side for an investor because it causes uncertainty. Uncertainty of discretion as well as its potential for abuse can be minimized by publishing the decision criteria upfront, making the decision with reasons transparent, and giving the investor the right to appeal.

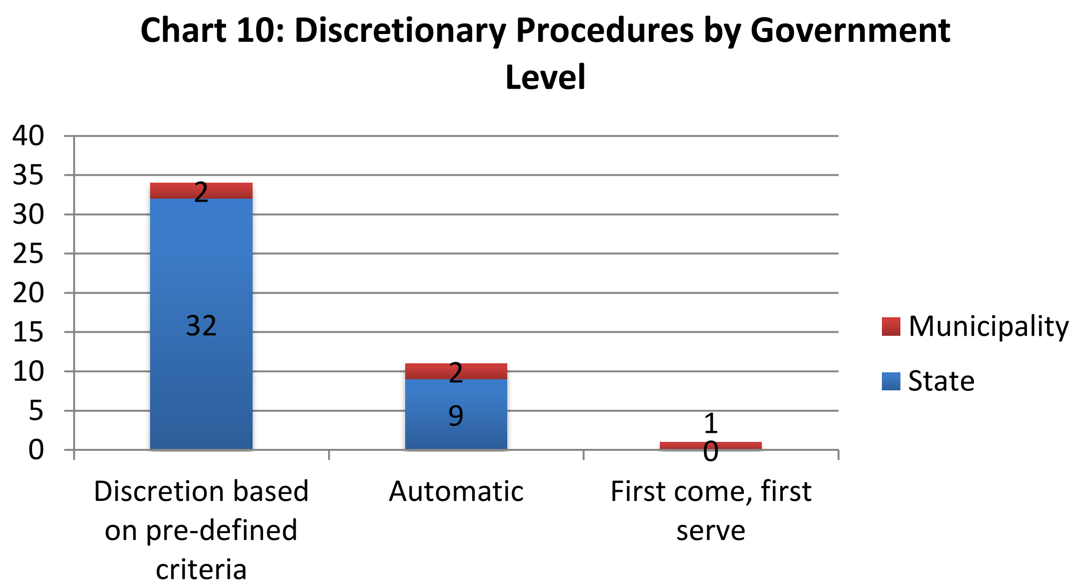
The inventory of incentives in Kosovo contains a relatively high number of discretionary procedures (**<u>34 out of 46</u>**). This is **<u>74</u>** percent of the incentives. Other categories are decisions based on a first come, first serve basis or an entirely automatic award.

Chart 9: Discretionary procedures of all incentives in Kosovo



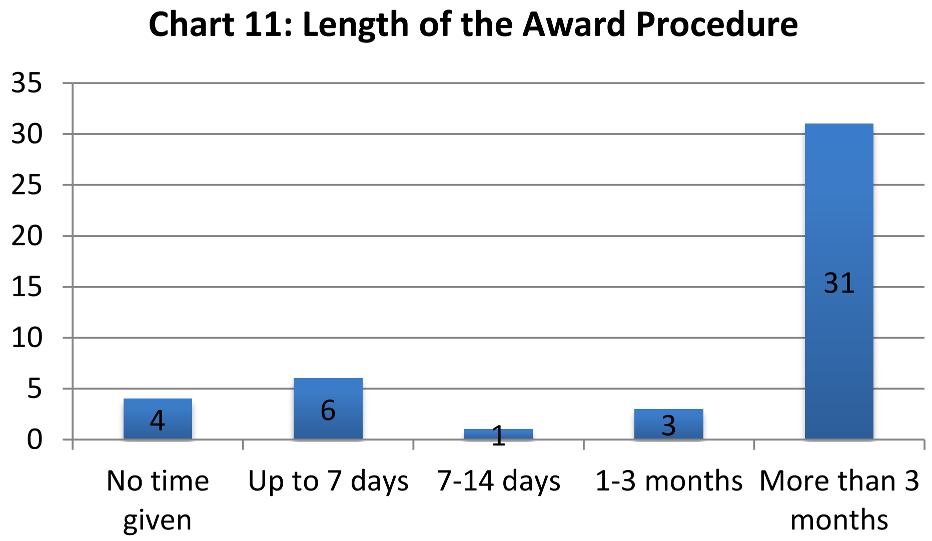
Looking at discretion by government level shows that the state and the municipalities award discretionary incentives.

Chart 10: Discretion by Government Level



The length of the procedure is an indicator for its efficiency. The longer an investor has to wait for a decision, the more uncertainty does it create on the investor side. Investment decision may be postponed, suspended or cancelled, if the decision is not received within a reasonable time frame. In Kosovo, only 7 of the 46 incentive decisions are delivered within 14 days, but 31 will take more than 3 months, see Chart 11. The procedures with a duration over 3 months are all for agriculture-related incentives.

Chart 11: Length of the incentive award procedure



EU State Aid criteria

The European Union (EU) needs specific information to assess the situation in Kosovo against the EU State Aid rules. Three criteria related to the state aid were included in the questionnaire: Is the incentive linked to an economic activity, does it create an economic advantage, and is the support of direct or indirect nature.

For the **46** investment incentives in Kosovo considered as investment incentives, all three EU questions are answered with "yes", meaning that all items qualify as State Aid under the EU rules according to our initial assessment based on data collected through the survey. All items are linked to an economic activity, they constitute an economic advantage for the recipient, and they are either direct or indirect.

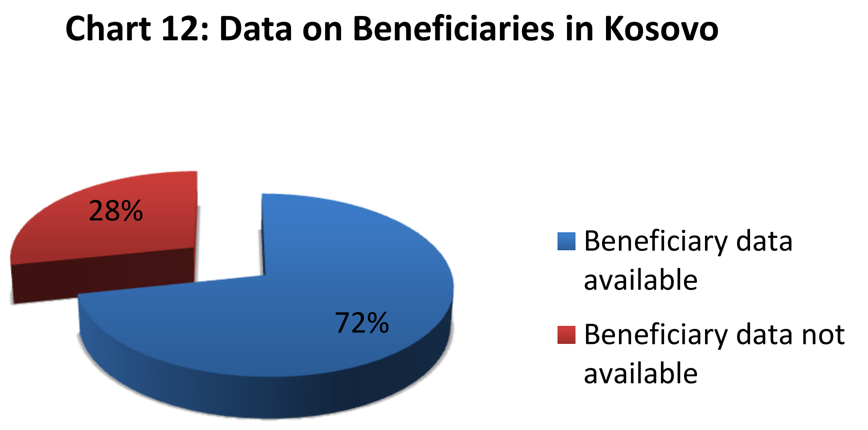
Recipients

For an analysis, monitoring and enforcement it is important that authorities document key information of the recipients.

The questionnaire asked for the number of recipients of the respective data. This question was answered for **33** out of the **46** items. It is not clear whether the respective data for the **13** items is not collected, not documented or simply not prepared. Consequently, authorities do not have data available on the recipients of incentives for **28** percent of the items, see Chart 12.

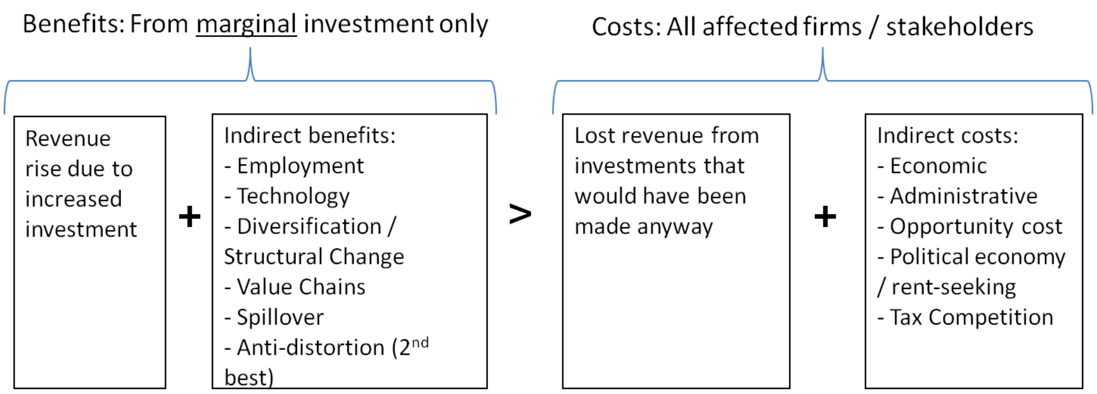
The number of beneficiaries ranges from as small as 7 up to 10,263 firms or entrepreneurs.

Chart 12: Beneficiaries in Kosovo



Costs of incentives

In order to assess the impact and revenue implications of the **<u>46</u>** items of the inventory for Kosovo and estimate the impact of incentives provided in all municipalities and cities of Kosovo, each incentive in the inventory has to be quantified in a comprehensive cost-benefit analysis. The picture below describes the data necessary to conduct a cost-benefit analysis of incentives.

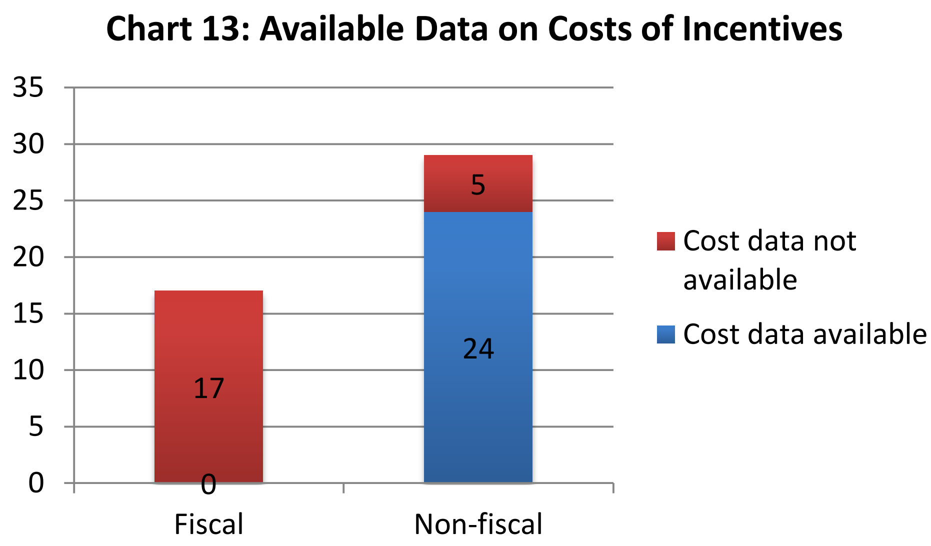


A comprehensive cost-benefit analysis is beyond the scope of this report. However, a first estimate of some of the costs of the incentives can be made by using the available data of the inventory. If decided by the Government of Kosovo, then further data collection could be undertaken to conduct a comprehensive cost-benefit analysis for specific incentives or groups of incentives.

Costs can be direct through financial incentives or indirect through forgone revenue. The team tried to collect the numbers for each item for the year 2012 but for **<u>22</u>** of the **<u>46</u>** items the information on the awarded amount was not available. Most of the missing data was on state level (**<u>18</u>**), however, on municipal level data was only available for **<u>1</u>** of the **<u>5</u>** items.

No data is available for the 17 fiscal incentives, while the picture for non-fiscal incentives is much better. Out of the 29 non-fiscal incentives, cost data is available for 24 of them, see Chart 13. The numbers below are based on the reported "awarded" amounts.

Chart 13: Data available on the awarded amounts in 2012 for fiscal and non-fiscal incentives



For **24** items, the total awarded incentives in Kosovo in 2012 are € **19,725,704**. The awarded incentives range from **€ 25,000 to € 3.8m**. Please note that these are the sums awarded under a general incentive and not awarded to a single beneficiary.

The average cost of an incentive in Kosovo is € **821,904**, the state € **836,770** and the municipalities is € **480,000**. The calculation is done by dividing totals with respective number of referenced incentives.

All of the calculated costs concern sectoral incentives, because the general incentives are fiscal incentives and no data is available for them. Since the vast majority of the sector incentives are spent on the agriculture sector (31 items), the overall average costs reflect the average costs of the agriculture incentives. The manufacture sector received one incentive item for **€ 480,000**, the SME sector one for **€ 200,000** and the awarded amount for the traditional crafts was not available.

Preliminary observations and potential reform measures

The inventory gives a detailed account of the incentives regime in Kosovo. It covers the state level and five municipalities. The five municipalities serve as pilots and provide a good first insight on the treatment of incentives on municipal level.

The inventory allows a preliminary appreciation of the incentive system and the provision of initial recommendations. More research and analysis would be required to develop more in-depth recommendations.

Preliminary observations

Investment incentives in Kosovo are considerable by number but not extensive. Incentives in Kosovo are typically based on a law, which states requirements and award criteria and the information is publicly available. This is according good practice. Furthermore, the following observations can be made:

- Kosovo provides incentives mainly on state level. Even though only 6 municipalities took part in the survey, it can already be said that the major part of the incentives are centralized on state level. This allows a high degree of coordination and oversight.

- At first sight, it appears that most incentives are non-fiscal grants. However, the fact that many of the non-fiscal incentives are agriculture incentives for single products inflates the number of non-fiscal incentives. Without the agriculture incentives, the relation from fiscal to non-fiscal incentives is much more balanced.

- Kosovo does not have regional incentives apart from SEZ/IP-related ones, and moderate sector incentives. Sector incentives favor strongly the agriculture sector and might be in part of social or environmental purpose.

- Though the procedures are transparent, the manner in which the information is presented is often not sufficiently user-friendly. Transparency means not only to provide the legal base as a download for investors. The information should also be provided in an appropriately processed way. Furthermore, procedures may take a long time from application to award. 31 of the procedures take longer than 3 months. Only 1 procedure takes less than 7 days. Although the length of the procedure depends on the complexity of the decision and a thorough decision takes it time, a process longer than 6 months appears extremely long.

- The actual awarded sums are significant. Though the numbers for fiscal incentives on state level were not available, the available data suggests that an average of over € 800,000 per incentive is awarded. For a country with a GNI per capita of about € **2700**, this is a considerable amount.

- The available data on the costs of incentives is patchy. While good data is available about the recipients of much of the non-fiscal incentives and the total awarded amounts, the available data on fiscal incentives is poor. The reason for this is unclear but it results in an inability to assess the costs and benefits of the fiscal incentive regime.

Potential reform measures

Judging from the findings in the inventory, Kosovo's incentive regime is in reasonable shape. It is based on law, strongly centralized, transparent, monitored, and in large parts non-discretionary. However, the inventory shows some areas, which could be improved to make it more effective and efficient. The following reform measure should be considered:

- Improve the collection of data on the cost of incentives, particularly fiscal incentives. Knowledge about the actual disbursement of fiscal incentives is inevitable for any analysis of the effectiveness of an incentive. At least for this inventory such data was not available. It is recommended to establish the collection of cost data.

- Increase the internal transparency and communication about incentives. The various incentive awarding authorities should coordinate their efforts, exchange key information about awarded amounts and recipients, and ensure that their incentives support an overall investment policy objectives.

- Improve the transparency on the web. It is welcomed that most awarding authorities have a web presence. However, the quality of information provided on the web could be improved with better presentation and comprehensiveness.

- Conduct a cost-benefit analysis of specific incentives. Considering the significant revenues disbursed or in forgone taxes, it is important that the policy-makers have information about their effect. What are the benefits for the state, how many additional jobs do the incentives create, what is their effect on the economic development, etc. A thorough cost-benefit analysis would provide such information.

- Improving targeting the incentives. The current incentive regime is characterized by many general (fiscal) incentives and a strong preference for incentives in the agriculture sector. However, well-designed incentive may support the development of other sectors with growth and development potential.

- Analyze and assess various procedures in detail. Considering that so many procedures are very time-consuming, it is worthwhile to assess the efficiency of them. Can the procedures be shortened? Can requirements be cut down? Can involved authorities be better coordinated? etc. A flow chart of each process would be necessary including the requirements and duration of each step. The standard cost model might be applied to selected procedures to assess their costs to investors and the gains of potential reforms for them.

- Review of the overall investment/incentive policy. Kosovo has 46 incentives in place. The question is to what extent these items a part of an integrated approach towards investments. Do they follow the same objectives? If so, are these objectives well chosen for the economic situation and growth potential of Kosovo? Or do the incentives overlap, duplicate, or follow conflicting goals? A review of the existing investment policy and incentive regime could give answers to these questions.

- Review the legal compliance of incentives in light of international obligations such as WTO, EU, etc.

Annex 1. International good practice of incentives

Forms and Objectives of Investment Incentives

Incentives shall motivate an individual or a group to perform a certain action.

Investment incentives or subsidies are synonyms for measurable economic advantages that governments provide to specific enterprises or groups of enterprises, with the goal of steering investment into favored sectors or regions or of influencing the character of such investments. These benefits can be fiscal (tax or import customs duty exemptions) or non-fiscal (grants, loans, public charge or fee reductions, regulatory privileges, etc.).

Investment incentives, fiscal and non-fiscal, are introduced to pursue various objectives.

In some cases, incentives may be seen as a counterweight to the investment disincentives inherent in the general tax system. For example, the corporate tax rate or the import customs duties are perceived as too high and offset with incentives. In other cases, the incentives are intended to offset other disadvantages that investors may face, such as a lack of infrastructure, complicated and antiquated laws, or bureaucratic complexities and weak administrative capacities, in the tax area or elsewhere. Sometimes incentives are introduced to keep up with other countries in competing for international investment. Sometimes, incentives are introduced after other deficiencies in law and administration are remedied and are directed to areas of economic activity that the country wishes to develop.

Countries using a range of fiscal and non-fiscal incentives may pursue a mix of the above objectives.

Are there alternatives to the use of incentives? Where fiscal or non-fiscal incentives are a reaction to deficiencies in the investment climate the most effective option would be to tackle the underlying problem, meaning for example adjusting tax rates, reforming tax and customs administration and procedures, improving administrative weaknesses or upgrading infrastructure. This solution is often easier said than done, and so incentives may provide temporary relief until the more fundamental reforms have been carried out.

Where, however, incentives pursue specific sector or regional objectives, targeted incentives can be an appropriate tool.

The Link between Incentives and Investments

The key question for a government is whether incentives can attract additional investments, and if so, under which conditions is this achieved most efficiently. In fact, much research has been devoted answering these questions. Conclusions from research and surveys on the relation of fiscal investment incentives and investments include:[7]

- Investors rate investment incentives repeatedly in Investor Motivation Surveys as one of the least important factors in their investment decision. Evidence from both surveys and econometric studies show that some of they key determinants affecting an investor's decision on where to locate is based on larger investment climate factors and economic

[7] Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications, Sebastian James, World Bank, December 2009.

variables such as market size, regulatory policies, natural resource endowments, and human capital availability.

- Tax holidays are particularly ineffective in attracting long-term investment, because they are unrelated to investment performance, the can easily be prolonged by closing down and opening a new business, they attract footloose businesses, business often do not make profits in the first years.

- The investment climate affects the effectiveness of incentives. Incentives have almost no impact in countries with a low Investment Climate. Incentives are eight times more effective in attracting FDI in strong investment climates than in weak ones.

- Investment incentives do not work for many firms that face financial constraints and cannot grow to take advantage of tax incentives.

- Investment incentives create significant distortions by encouraging inefficient investments.

- Highly mobile investors and export-oriented investors are sensitive to incentives – especially tax incentives, while investors oriented toward domestic markets are less sensitive to incentives.

- The cost-benefit analysis of investment incentives can be particularly positive when the investment assets are available to the general public (e.g. road, school). It is another way to pay for public goods. Investments generating positive externalities like encouraging green technologies, upgrading skills of workers, anchor investments (but have to be justified), infrastructure.

The presented conclusions were almost entirely addressing fiscal incentives. The relation of non-fiscal incentives and investments is less clear. This is mainly because the term non-fiscal incentives includes much more diverse types of incentives than fiscal incentives, which makes it more difficult to identify common characteristics, approaches and tools. In fact, the effectiveness of each category of non-fiscal incentives would have to be assessed separately. Solid tools and criteria for a comprehensive assessment of non-fiscal incentives are not available yet.

However, a first approach to assessing non-fiscal incentives could be procedural. The award of non-fiscal incentives is based on a decision of a public institution after an administrative process. The process and the institutional performance should fulfill good governance principles.

Annex 2. Definition of Investment Incentives

Definition of Investment Incentives

Investment incentives can be defined as ‘measurable economic advantages that governments provide to specific enterprises or groups of enterprises, with the goal of steering investment into favored sectors or regions or of influencing the character of such investments. These benefits can be fiscal (as with tax concessions) or non-fiscal (as with grants, loans, or rebates to support business development or enhance competitiveness).’[8]

Forms and Types of Investment Incentives

The broad definition of ‘investment incentives’ suggests that a very large number of different investment incentives exist, such as derogations from fiscal policies, grants, soft loans, access to free or subsidized land, support in training and employment, infrastructure subsidies and ad hoc exceptions. The range of possible investment incentives offered to investors is potentially unlimited.

Investment incentives can generally be categorized in three different types: regulatory incentives, financial incentives and fiscal incentives. (Occasionally, there is only one differentiation made, between non-fiscal incentives and fiscal incentives. In this case, regulatory incentives and financial incentives form together the category of non-fiscal incentives).

<u>1) Fiscal Investment Incentives</u>
Third, the most commonly used investment incentives are fiscal FDI incentives. (Due to the focus of this note on non-fiscal incentives, the following lists the main fiscal investment incentives only briefly):

- Reduced direct corporate taxation, such as tax holidays and special tax-privileged investment zones.
- Incentives for capital formation, such as special investment allowances, investment tax credits, and reinvested profits.
- Reduced impediments to cross-border operation, such as withholding tax, taxation of foreign trade, taxation of employees.
- Other tax reductions, such as lower sales taxes and VAT reductions, property tax reductions, and lump sum tax models.

<u>2) Financial Investment Incentives</u>
Financial investment incentives is a broad category covering those investment incentives that grant the investor a financial advantage by supporting the investor in ways that reduces the investor’s costs relating to both the establishment and operation of the investment. Financial investment incentives may be categorized as follows:

Employment incentives: Employment incentives are investment incentives reducing the investor’s staff costs, often through human wage subsidies. The host government regularly justifies employment incentives with the spill-over effects to be expected from the investment.

Training incentives: Particularly in case of a shortage in qualified employees in a host country subsidized training programs can help attract an investment and provide for host country benefits in improving human capacities.

[8] James, Sebastian. 2009. *Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications*. See further: ’Investment Law Reform Handbook.’

Financing incentives: Financing incentives aim at facilitating an investment by offering financial support to the investor mostly relating to the start-up costs (occasionally also relating to operating costs). Financial incentives can take different forms, such as subsidized loans, loan guarantees, cash grants, or even public sector equity participation.

Provision of physical infrastructure: Investment incentives consisting in the provision of physical infrastructure aim at reducing the costs investors face for real estate and transport facilities. National or local authorities may sell public land (below market price) and provide infrastructure such as roads, railways, harbors, communication infrastructure etc., if the need of an investor for such a service is assumed or established.

Special Economic Zones (SEZs): A prominent feature of investment attraction strategies are incentives offered through various types of development zones, such as export promotion zones or industrial parks. These zones usually combine various types of fiscal and non-fiscal investment incentives to offer a very attractive package of benefits to investors including physical infrastructure, special attention by relevant authorities (aftercare) and tax breaks. Further benefits for investors and the domestic industry are assumed to develop through the emergence of industry clusters within or around the zones.

Support in business set-up: Investors have special needs in terms of setting up their business, including information on availability of land, domestic rules and regulations, needs in marketing of their products and services and help in general administration. Investors may also appreciate support in meeting and cooperating with local officials, suppliers, service providers, and other investors. These functions are often provided free of charge by the domestic investment promotion agency. Depending on their character, these services may amount to an implicit subsidization of the investment.

Aftercare services: Closely related to the support in business set-up are aftercare services as constituting a follow-up service for the investor helping to remove obstacles and solve problems the investor faces in their start-up and operations. Host countries may offer these services in an effort to build a long-term, collaborative relationship with the investors.

<u>3) Regulatory Investment Incentives</u>
Regulatory investment incentives are any type of incentives offered to foreign investors by way of derogation from national rules (including rules and regulations on the sub national level). According to the OECD, there is little concrete evidence for wide-spread application of regulatory investment incentives. One reason for the low numbers of regulatory investment incentives noted may be that derogations from national policies can take the form of a relaxation of environmental, social and labor-market related requirements for foreign investors. In these instances, host countries and investors may not be keen to communicate these incentives publicly.

State Aid

In addition to the above definition of non-fiscal investment incentives the EU definition of the term “state aid” should be taken into consideration for final definition of the term “incentives” in order to comply with the EU regulation. Also, the final definition of incentives in context of the work in Kosovo should be in line with the recently adopted the Kosovo Law on State Aid that is compliant with the EU regulations.

EU rules

<u>Prohibited State aid</u>

The EC Treaty pronounces the general prohibition of State aid to ensure that government interventions do not distort competition and trade inside the EU. A company has received a prohibited state aid in the case if the support meets the following criteria:

1. there has been an intervention by the State or through State resources which can take a variety of forms (e.g. grants, interest and tax reliefs, guarantees, government holdings of all or part of a company, or the provision of goods and services on preferential terms, etc.),
2. the intervention is likely to affect trade between Member States,
3. the intervention confers an advantage to the recipient on a selective basis, for example to specific companies or sectors of the industry, or to companies located in specific regions,
4. competition has been or may be distorted.

Allowed State aid

The EC Treaty pronounces the general prohibition of State aid but also contains a list of possible circumstances in which State aid may be granted for a well-functioning and equitable economy. Therefore, the Treaty leaves room for a number of policy objectives for which State aid can be considered compatible. In general, these include developing disadvantaged regions, promoting small and medium-sized enterprises (SMEs), research and development (R & D), the protection of the environment, training, employment and culture. Precisely, the Commission Regulation (EC) No 800/2008 of 6 August 2008 declares certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty. The categories of aid covered are the following:

- regional aid, allocated according to the map for regional aid in the period 2007-2013. They are targeted at investment and employment, as well as newly-created small enterprises in regions;
- SME investment and employment aid;
- aid for the creation of small enterprises by women;
- aid for the protection of the environment, in particular those allowing enterprises to go beyond Community standards, taking the form of tax reductions or encouraging investment in energy saving and the promotion of renewable energy;
- aid in favor of SMEs, to allow them to benefit from consultancy services and participation in fairs;
- risk capital aid, for participation or management of a profit driven private equity investment fund, managed on a commercial basis;
- aid for research, development and innovation, in particular concerning cooperation between research organizations and enterprises, intellectual property rights costs for SMEs, innovation support or the loan of highly qualified staff;
- training aid;
- aid for disadvantaged or disabled workers.

Also, the Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to de minimis aid specifies that the aid not exceeding a ceiling of EUR 200 000 per company over any period of three fiscal years do not constitute State aid as it does not affect trade between Member States and/or does not distort or threaten to distort competition, and they can grant these amounts of aid without any procedural burden. The total *de minimis* aid granted to any one undertaking active in the road transport sector shall not exceed EUR 100 000 over any period of three fiscal years.

Annex 3. – Inventory of investments and non-investments incentives in Kosovo – attached as an Excel file.