

Public policy brief for state aid:

Is state aid a factor in attracting foreign direct investments?

FDI in the Western Balkans

Challenge:

- *The "race to the bottom" phenomenon occurs when the country on one hand, reduces taxes and, on the other hand, increases the state aid to foreign companies in order to attract more foreign direct investments. If such policies are not adequately designed and implemented, they can cause public revenue erosion in each country but also regionally. This phenomenon is especially pronounced if the foreign direct investments do not contribute to economic growth and economic development.*

Recommendations:

- *The countries in the region should enhance the efforts for improved transparency level of the state aid granting process, strengthen the effectiveness of the parliamentary oversight, and increase the role of civil society in state aid monitoring.*
- *The strategy of attracting foreign companies in the WB region should be coordinated (increased regional cooperation) and be a combination of short-term measures through state aid in a responsible and transparent manner and long-term measures to strengthen institutional systems and the economy.*

State aid in the Western Balkans region

Typically, countries that are formerly planned economies in the transition phase to market economies use different forms of tax and other non-tax breaks to attract foreign companies for foreign capital – the countries in the Western Balkan are not an exception.

As countries aspiring to full EU membership, Western Balkan countries have largely adopted the European legislation on state aid control, however

the EC's regular progress reports note the need for enhanced transparency in the process of granting state aid as well as the need for an effective enforcement of the regulations.

State aid control is a concept specific to the European Union, with the aim of protecting the common European internal market. As the European national economies and markets are not characterized by homogeneity, "supranational" control of state aid is more than necessary to protect the public interest, hence, all candidate countries are

negotiating under *Chapter 8, which deals with competition protection and state aid control within the internal European common market.*

Although the EU sets certain limits on the candidate countries on the amount of approved state aid, the Union is not so restrictive in terms of the forms of state aid until their full membership, which puts them in a more favorable position compared to the EU member states while attracting foreign direct investments.

In addition to *state aid and low taxes*, the WB region has other benefits such as the *geographical proximity to the large European market, the free trade agreements with the European Union and other major economies, cheap labor and a high percentage of the highly educated unemployed.*

The essence of state aid is that it *must not distort competition in the internal market.* State aid is only justified when it is an attempt to correct market imperfections or when it is intended to achieve certain social goals or measures aimed at protection of the environment.

The parliaments of the Western Balkan countries are responsible for the oversight of the state aid policies, however experience shows that the process is primarily focused on the formal aspects of received annual reports from the responsible authority for control of the state aid than on the essence of oversight, thus due attention is not paid to the *efficiency and effectiveness of the state aid policies.*

Hence, there is a risk that in the process of attracting FDIs, the countries may reach out to discretionary, non-transparent and harmful decisions for granting state aid, instead of granting state aid as part of

socio-economic policies for improved performance of the national economies.

In this manner, when attracting FDI, countries risk increasing public spending and decrease public revenues, often by lowering tax rates for better attractiveness of foreign capital.

By competing with neighboring countries in building the image of the most favorable destination for foreign investments, countries can easily fall into the "race to the bottom" trap.

What do the indicators say?

The data show that countries in the Western Balkan region that have higher value of state aid also have higher inflows of foreign direct investments. However, it is also noteworthy that *countries in the region with higher economic growth also have higher foreign direct investment compared with the countries with lower economic growth.*

Furthermore, the data suggest that, *contrary to expectations, the three countries with higher profit tax rates (Serbia, Slovenia and Croatia) have higher inflows of foreign direct investment*, while countries with lower profit tax rates (North Macedonia, Bosnia and Herzegovina and Montenegro) have lower inflows of foreign direct investments.

It is clear that the countries in the region which are EU member states, are using broad measures to attract FDI compared to the neighboring non-EU countries which are using narrow measures with lower tax rates to attract FDI.

In other words, North Macedonia, Montenegro, Bosnia and Herzegovina, and

Serbia, are “paying” a higher “premium” to attract FDI through lower tax to GDP due to the “inability” to compete with rule of law, corruption control, trust in institutions areas in which Croatia and Slovenia are more competitive.

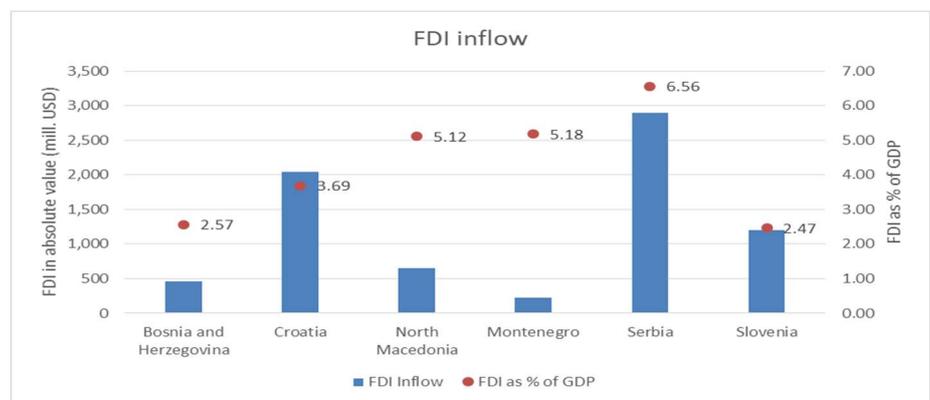
This leads these countries to the practice of “beggar-thy-neighbor”, when the countries are trying to overcome each other with stimuli and incentives to attract FDI, causing a “race to the bottom”.

The causality test indicated that with a time lag of six periods, the growth trend of the gross domestic product predicted the trend in foreign direct investments, while with a time lag of two periods the trend in the granted state aid predicts the trend in foreign direct investment.

Hence, the empirical analysis for the countries in the WB region (North Macedonia, Serbia, Albania, Kosovo, Montenegro, Croatia, Slovenia, Bosnia and Herzegovina) for the period (2008-2018)

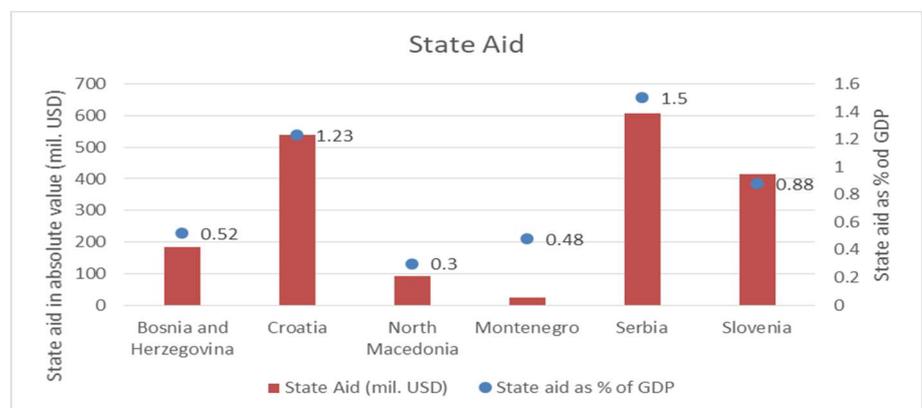
Graph 1: Foreign Direct Investments in the Western Balkan countries

Source: Data from World Bank <https://data.worldbank.org/>



Graph 2: State Aid in the Western Balkan countries

Source: National authorities for competition protection and state aid control



What are investors attracted to?

The empirical analysis shows that there is a *positive correlation between foreign direct investment and the gross domestic product growth, but also between foreign direct investment and the granted state aid within the WB countries.*

shows that *state aid has a positive effect on attracting foreign direct investment in the short-run, but in the long-run foreign companies are directing their capital to the countries with high GDP growth rates.*

On the other hand, this can indirectly mean that *sustainable FDIs are looking for stable and developed markets where rule of law prevails and where there is institutional trust.*

Recommendations

- Strengthening and clear criteria and procedures for granting state aid while *discarding the strategy for attracting FDIs which relies mostly or only on granting state aid* in a non-transparent manner;
- Availability of data and information not only of the allocated state aid but also availability of *cost and benefit analyzes for the granted state aid*;
- Forsaking narrow measures, such as *low profit tax rates*, as an argument for attracting foreign direct investment to countries in the region;
- Recognition of the importance of the *rule of law, trust in institutions, control of corruption*, in attracting FDIs, which are the primary motives of the foreign investors in choosing the destination for their investments.

This Policy Brief is based on the *Public policy study: Attracting foreign investments in the Western Balkans and state aid: race-to-the-bottom or necessity*, developed as part of a Center for Economic Analyses' (CEA) project entitled: *Competition and State Aid Policy Monitor: 8 Matters!*. The project received funding support from by the Swedish International Development Agency (Sida) through the "Nordic Support for Progress of North Macedonia" Project implemented by the United Nations Office for Project Services (UNOPS). Full Report Available at <https://cea.org.mk/>

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