BANK OF ALBANIA

COMPARATIVE ANALYSIS OF TAX SYSTEMS WITH SOME COUNTRIES OF THE REGION

Dr. Selami Xhepa*

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* Dr. Selami Xhepa is segnior economist at the Research Department, Bank of Albania.

BANK OF ALBANIA, Sheshi "Skënderbej", No.1
Tirana - ALBANIA

Tel: 355-4-222152; 222153, 222156

Fax: 355-4-223558

Telex: 2153 BANKA AB.

E-mail: intlrel@boa.tirana.al

Home page : www.bankofalbania.org

Copies : 500

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ABSTRACT

The idea of preparing such a working paper came with the change of the tax system at the beginning of 1998. The used argument to justify this measure was that our country had the lowest level of taxes in the region and that there were still spaces to their extension, that foreign capital attraction based on a liberal system regime, already adopted by our country. As really tried to be evidenced by the subsequent paper, neither of these arguments based on a well-grounded terrain.

The fact why Bank of Albania considers the analysis of fiscal policy as interesting, is that capital costs do not only involve money costs expressed in the type of credit rates but also fiscal ones expressed in the form of the fiscal charge, investors must pay. Should both of these policies, the fiscal and the monetary one, be not prudentially harmonized, neither of these impacts will be managed to attain on the whole of their potential length. Should the fiscal charge be high and expansive to direct investment costs, this may be discouraging for investors finding debts to finance the project. As of this, the policy of cutting interest rates will not reach the expected efficiency from the monetary authorities and the market, itself.

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1. Introduction

Even in the best terms and standards of legal and administrative dealing with investments, the broad liberalizing movement that has seized the world economy, currently, has expanded the market size for operating companies. As such, liberalization may be considered a distinguishing element in the attraction of capitals. Tax systems and fiscal advantages, offered, are ever more used as competition instruments.

Frequently used in the public debate to empower decisions on rising tax and duties, financial authorities of the country have propagated that our tax rates are amongst the lowest of the region, in fact. In this writing piece, we will cease by the comparative analysis of fiscal charge. A comparative survey on applicable tax and duties involves three countries of the region, for which, we had the opportunity to find available data[1]. Also in terms of installing an investment project, these countries may be competitive nominees to our country. Any investor, intending to serve the Balkans market would see the feasibility of installing a project in one of the countries taken under analysis. In the SWOT analysis to be performed, the weight of cost factors, primarily of tax systems will be one of the most important to be considered in an investment decision. As of this, differences in the fiscal systems dealing with investments become instruments of a regional competition. There are two questions we try to answer:

- In what ratio does the fiscal charge of our country investors stand to other countries included in analysis; and
- Has the changed fiscal system been effective to our country for the period from 1997?

[1] The data are taken from these countries business guides published in web-site. The status of information on its freshness is frequently unspecified. In any case the word "investors " implies either domestic or foreign ones. On the whole, national legislation dealing with investments contains clauses of "national regime" principle, which means equal treatment for domestic and foreign investors.

The comparative analysis of fiscal system has frequently met with the difficulty of finding information on respective legislation. On the whole, regional countries have no transparency on their fiscal systems. Apart stiffening the analysis, this had its own impact in the rate of precision of competitive positions and the uniformity of analysis. For example at data deficiency, it is impossible to analyze operating costs (and variable costs, generally). This may remain a duty of a further study, ongoing.

Being a working paper prepared for discussion, remarks, comments and suggestions are welcomed.

2. Evidence performed studies

Fiscal charge impact on investment process (and economic growth of a country) has been subject of several studies performed by different authors. The theoretical basis of these studies' relies on two economic theories, known as Kejns and neoclassic trends.

According to **Kejns** theory on the aggregate demand, the reduction of government expenditures or the rise of taxes decreases the aggregate demand and income indirectly, transmitting a negative impact in output. This theory in its complete model presented by the standard analysis of IS-LM curve, the multiplicator of negative effects is partly offset by the crowding-in[2] effect as to the lower interest rates and monetary depreciation.

Neoclassic models accentuate other transmission mechanisms through which reductions in the budgetary deficit of state affect the economy positive effects that may exceed the negative impacts of Kejns multiplicator in the aggregate demand. A lower budgetary deficit would significantly reduce intrest rates because of the falling risk conceived that government might depreciate the public debt through a higher inflation rate, so leading to positive returns (equity) on the aggregate demand. A country suffering from striking imbalances of budgetary deficit where measures to its reduction are regarded as necessary to reset government insolvency, the reducing deficit would also affect the reducing price of intrest rates' risk. Such a thing would also increase the value of the equity market of the private sector and the aggregate demand, consequently. Government reducing deficit would also serve as a signal for future reduction of fiscal charge and rising income for the private sector and customers, which may still trigger the increase of expenditures and their economic activity.

Special studies on the relationship between the fiscal charge and the economic growth rate (thus the incitement of investment process) have finally reached to some conclusions as below:

Examining the customs tariff impact in the economic growth rate, Knight et al. (1993) have confirmed[3] that: the level of tariff on capital and intermediate goods bears a significant effect on the economic growth rate; countries having lower tariffs grow faster, than those applying high ones.

Lee (1994) concludes that not only and merely trade, as such, is important for the economic growth rate than trade composition, implying higher growth results when the main contribution in the import structure comes from high imports in capital goods.

Schmenner et al. concludes that the rate of profit tax enables the possibility that a country (state) enter in the short-list of nominees (countries) for installing a project.

Although using fiscal incentives is a contradictory matter of literature and empirical analysis[4], the recent studies confirm that tax and duty levels have a powerful influence in setting fair balances between savings and investments and economic growth, as aftermath.

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[2] Reducing inflation drives at lower interest rates encouraging private investments and consumption as aftermath.
[3] References are taken from Philip Gerson (1998)" The impact of fiscal policy variables on output growth", IMF WP /98/1.
[4] A study performed from the National Bank of Bulgaria drives in the conclusion that fiscal agents provided by Bulgarian law on foreign investments are much more positive in terms of economic growth than negative in the terms of budget income loss. (see:www.bnb.bg/ working papers rubric).

3. A short overview on the fiscal and duty systems of some countries in the region

The subsequent analysis does not pretend to illuminate fiscal policy effects in ratio to savings and investments and economic growth rate. Should a project installing in one of these countries under analysis be at a certain extent affected by the fiscal policies[5], then the comparative analysis is very important and may serve as a response to the neutral and/ or competitive policies.

Box. 1: Other influential factors in the decision-making for installing a project.

We evidence that in terms of other factors affecting the process of decision-making for installing a project, our country occupies the most unfavorable positions. Amongst the core considerations are the political situation, infrastructure and cost factors. Whether making comments for the first two elements to prove our country's disadvantage is unnecessary, in terms of cost factors (such as power and other input prices, labor force costs etc- a more detailed analysis is under way) our country does not disclose to enjoy advantages or counterpoise advantages, less. Only and simply the analysis of wage indicators of labor force can not illuminate aspects of competition, as the competitive element is not wage similar, but labor force productivity and costs per unit of product, which analysis is not a subject matter of this study.

The following analysis specifies two moments of investment process: the fiscal charge and project's rising costs before it becomes workable (before an enterprise starts functioning and be profitable) and fiscal charge impact on project returns or profitability (related to investment repayment term) [66.] As based on such analysis, we have performed a synopsis of our country's competitive position. What must be stressed is that the analysis is not totally

[5] the fiscal charge for installing an investment project, generally, comes immediately after the analysis of the political stability and the legal safety and protection environment of investors from expropriations, profit transfers, etc.

unique for all the countries, but it is also dictated by our capacities for finding useful data and estimation is more intellectual than empirical.

3.1 Albania

- *Costs before starting an investment*

Additionally to costs related to buying technology, investors must also add in their business plan immediate payments to be made precisely for:

Customs duties (for machinery and equipment and other capital goods) at 5 percent (as many goods categories such as raw materials have 10 percent tariff minimally);

VAT[7] at 20 percent over the purchasing sum of the bill (purchasing price + freight + insurance expenditures) plus customs tax.

Cumulative costs to fiscal charge effect are at 26 percent higher, at least.

- *Investment profits and investor costs*

Profits eraned by the economic person or enterprise are subject of 30 percent tax. Dividends, interests and other net profits earned from economic activity domestically are subject of 10 percent withholding tax for residents and 15 percent for non-residents.

Labor force costs are also increased by nearly 42 percent per performed payments for the social and heath insurance[8] network.

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[6] In this sense, the capital cost is examined as function of fiscal and non-monetary variables (credit rate).
[7] Although VAT is a refunded expenditure from the fiscal authorities its refunding term is relative to a longer period of time that comes alongside with the time when the enterprise begins to sell ready-made products. The legal dispositions on customs duties comprise a transgression of tax "maturity" principle and must be corrected as aftermath. (See: "On improving structure of fiscal reform" by Habah Hilmia, year 1997.
[8] Although, fiscal charge is party paid by workers, in the kernel, they represent fiscal taxes for investors in terms of a given level of wages. The analysis of that fiscal charge impact was not enabled as to the lack of data.

3.2 FYROM

- *Costs before starting an investment*

Foreign companies willing to operate in FYROM are exempted (for 5-years, at least) from customs tax on imported machinery and equipment (capital goods), as part of investment project. (Customs tariffs go from 0 to 60 percent[9]).

The basis of tax over the sales (VAT) is at 25 percent, whereas the level of this applicable tax for imported capital goods, rural machinery and basic foodstuffs is at 5 percent.

- *Investment profits and investor costs*

Profit tax is basically applied at 15 percent rate (whereas the applicable tax for services is at 13 percent). Foreign companies enjoy exemption from this tax in the first three years of their operation. Reinvested profits are exempted from profit-tax. Profit return from FYROM to the country of origin is subject of 10 percent withholding tax.

The withholding tax is applicable at 23 percent (for bank interests, equity profits, dividends, etc).

Investor fees on employment comprise:

Employment fund contributions	1.5 për qind
Health insurance'	8.6 për qind
Pensions'	20 për qind
Total:	30.1 për qind

[9]The stimulus through custom tariffs is doubled: through 0 percent tariff for investment goods and a high customs tariff for ready made products, protecting the domestic enterprises from the competition of foreign products.

3.3 Bulgaria

- *Costs before starting an investment*

VAT is applicable at 20 percent rate.

Foreign companies enjoy these advantages:

Machinery and equipment, technology, licenses, industrial models, trademark, know-how etc are exempted from VAT and customs tax, if investments are over USD100 thousand and have no less than a 5-year stretch.

- *Investment profits and investor costs*

The applicable profit tax on economic activities is at 40 percent (and 30 percent for companies having an annual profit up to BGN 1 million) and 50 percent for banks.

Withholding tax is applicable at 10 percent (for dividends paid by foreign or joint-venture companies) and 15 percent (for interests, royalties and other duties, etc).

Social insurance contribution is totally at 35 percent (whereas for foreign citizens employed by these companies is at 20 percent).

Fiscal facilities offered:

provide three-year exemption from profit tax at the beginning and 50 percent discount for the next three years of activity. Even this facility is offered on some terms (like the capital size over USD 5 million and on 50 percent foreign participation, foreign companies up to 2001, employment of unable or rehabilitated employee's etc).

3.4 Romania[5]

- *Costs before starting an investment*

According to the current legislation, foreign investors enjoy these facilities:

Machinery & equipment, installations, transport vehicles, know-how and other goods subject of amortization earn *exemption from customs tax and the Value Added Tax,*

Raw material, consumption assets, spare parts and components pay only 50 percent customs tax for the first 2 years,

Amortization of technology within 5 years;

Transfer of losses for 5 years in succession.

Such facilities are subject to these terms: investments must be no less than USD 350 thousand and have no less than 20 percent of participation in another enterprise.

- *Investment profits and investor costs*

The applicable profit is at 15 percent tax for the first two years of activity and its fixed rate is at 38 percent.

For over USD 5 million investments, profit tax (15 percent) is offered for another 5- year term. In this case, the 50 percent discount from customs duty is given for another 3-year term.

[5] Në dallim nga vendet e tjera të rajonit, Rumania është i vetmi vend i një ekonomie të mesme (ndërsa vendet e tjera janë ekonomi të vogla) e, për rrjedhojë, ajo gëzon dhe avantazhet e ekonomisë së shkallës.

Concise statement

Making a syllabus of these figures in a table form, it would be outlined the following scheme:

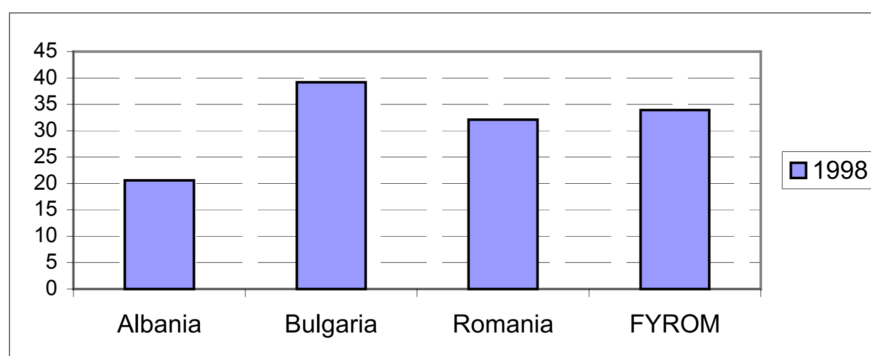
	Costs before investment		Profits earned		Remarks
	Customs tax in %	VAT in %	Profit tax in %	Resource tax in %	Other effective elements
Albania	5	20	30	10 (15)	No facility
FYROM	0	5	15	23	• 3-year exemption from profit tax, • reinvestment is exempted from profit tax,
Bulgaria	0	0	40	10 (15)	• 3-year exemption from profit tax, • 20% profit tax for other 3 years,
Romania	0	0	38	?	• 15 % profit tax for the first 2 years, • 15 % profit tax and an additional 5-year term for over USD 5 million investments.

Notwithstanding the fiscal facilities offered, budget income in ratio to GDP are presented as higher in all countries under analysis compared to our country (table 1).

Table 2. Total of income, as % of GDP.

	1998
Albania	20.6
Bulgaria	39.2
Romania	32.1
FYROM	33.9

Chart 2. Fiscal income as percentage of GDP-1998.



To make the compatibility of these data it is taken a hypothetical example (attached) on which basis we may assess the compatibility of fiscal system and discrepancies in competitive terms.

The supposed project where fixed assets cost (machinery and equipment to be installed, their purchasing price from producer) is USD 100 thousand.

At the moment of importing fixed assets (year 0), the weighing cost at the moment entering the customs border discloses as reverse as to the different fiscal regimes.

Entering our country, an investor must pay:

The c*ustoms tariff***:** purchasing price* customs tariff (5%) = USD 5,000,

Value Added Tax: purchasing price together with the customs tariff (USD 105,000)* VAT (20%) = USD 21,000,

the total cost of installing technology: = USD 126,000

Should this project be installed in FYROM, the investor must to pay only 5 percent VAT, meaning that fixed assets cost is at USD 105,000. Investment projects in Bulgaria and Romania are exempted from the payment of VAT and customs tax. (Customs tax facilities are also expanded on raw materials to be used in the five years taken under analysis, and operating costs would be lower, consequently. To hold a simplified example, these items are not included in analysis).

As noticed, costs before starting an investment in Albania are raised at 26 percent compared to other countries' under analysis.

Continuing the analysis on dealing with the profit tax impact on the profitability of project, it is supposed that in the first year of operation, it generates a gross profit of USD 1,000.

Net profit after the profit tax discount (in our country's case, 30 percent) at the end of the fifth year (total of net earnings) appears as reverse for each country under analysis. Even profitability index (calculated as ratio of the total of net earnings to the total of performed investments) indicates significant differences between the countries.

4. Features of fiscal legislation in Albania

Initially the fiscal system adopted (1992) used broadly as instruments of stimulating private undertaking, a series of fiscal facilities starting from exemptions from profit tax, customs duties on investment goods, not-applying tax on dividends, etc. This system has broadly and periodically evolved. In 1993, the exemption from profit tax discounted from 10 to 4 years, in 1995, it was removed the exemption from customs duty for machinery and equipment to finally reach in1998, where no fiscal facility was any more applicable. Essential features and changes in the new legislation include:

A unique profit tax at 30 percent for all types of activities (such a tax rate is the average applicable by OECD countries). Although the law is not specific, it let's to apprehend such unified tax rate is also undertaken for tourism, petroleum and gas sectors, which were previously applied at 40 and 50 percent rate, respectively,

A 15 percent withholding tax is applied for non-residents (10 percent for residents) on dividends, profit appropriation, interests and commissions on copyright and royalties.

Other important features of the new legislation related to dealing with discount expenditures to profit calculation effect are not recognized as discount expenditures:

Credit rates that exceed Bank of Albania's admitted maximum. The prepared guideline by the Ministry of Finance on this point refers to second-tier banks' refinancing rate, specifying that the interest rate published at the previous year ended at December 31 is taken as basis for the current year. If the considered interest rates will be for tight monetary policy terms, this may result of negative impacts for businesses. For example, the refinancing rate in 1995 was 20.5 percent, while the applicable intrest rate for the 12-month credits in the ensuing year (1996) was 28.8 percent. If an investor received a

loan in 1996, intrest payments per 8.3 percent difference would not be recognized as discounted expenditure to him,

The increase of companies' equity (capital) is not recognized as discounted expenditure,

To prevent the operation of high debt companies, the established ratio for debt-equity is 4:1,

Machinery & equipment applicable discount rate is at 20 percent,

Companies can transfer losses gained in the previous three years (not recognizing the accumulated losses over 1997-1998).

However, have the computed fiscal changes proved of positive effect?

From the analysis of fiscal indicators in our country (table 2), there are no indicators to confirm that the current tax system on investments has been gainful to our economy. Despite that after 1997, there have been dismissed all preferential dealings with investments; the total of fiscal income (in ratio to GDP) remains 15.9 percent below this indicator for years 1993-1996.

Excluding incomes earned from the exercise of VAT and the personal income tax, which are almost the same with the increase of the fiscal rate, other items are not improved and more precisely:

Amongst the eliminated facilities is *profit tax.* Budget incomes under this item for period 1993-1996 rest at the average of 1.8 percent of GDP. With the elimination of this fiscal facility, fiscal incomes from this item have declined into 0.9 percent of GDP for period 1997-1999, thus, they are almost half. *Customs income* comprised 2.9 percent of GDP for 1993-1996, while they have descended in 2.5 percent of GDP for years 1997-1999 (or -13 percent) although imports disclose a year on year growth (Imports during 1999 were at 53 percent higher compared to1993. Even estimations on imports' changing weight in ratio to GDP do not supply justifying evidence). Incomes deriving from other items, such as the small business tax, national

and local taxes, etc also marked decline and might be considered as indicators of a private sector's less dynamic operation, as well.

Even if we evade the 1997 effects, still indicators for years 1998-1999 confirm the same rates. Implementing the new fiscal policy confirms a significant growth of budget income from consumer tax (VAT and private income), as other budget incomes from the economic and trade activity have almost maintained the same declining tendencies in ratio to GDP.

5. Conclusions

Being considered as high risk countries (in terms of political safety and economic instability), investors aim to hold low initial costs of investments, something that would increase the project profitability in the first years and enable a fast return on invested capitals within an as shorter term, as possible. Thus, the major consideration before installing a project, (also bearing in mind that the majority of foreign projects in the region are of a short- and mid- term nature - as evidenced by several study organizations and international institutions) is the fiscal charge in the first years of performing investment. It is investors' motive that makes the competitive position of regional countries in effort to attract investments, become important.

From comparative data analysis with some countries of the region, it results that: costs before an investment project becomes functional are only as an aftermath of the fiscal charge staying respectively at:

Albania +26 %

FYROM + 5%

Bulgaria and Romania 0%

Project profitability rates are higher in other countries of the group under analysis and lower in Albania.

From what above mentioned, it results that Bulgaria represents the main competitor in terms of enticement as to the fiscal system effect, tracked by FYROM and Romania. However, since the facility system of Bulgaria is temporary exclusive, FYROM might be the most preferred for investors.

From the scrutinized data, it seems that the change of the fiscal system has not managed to generate positive effects in maintaining previous ratios of their contribution in domestic output. Probably a reduction of the fiscal charge for the exercised economic activity may be more stimulating for the economy and the state budget, itself.

It is necessary to make a revaluation of the fiscal policy, especially, with respect of dividing the fiscal duty between the rich and the poor groupings of the society in the re-industrialization process. It seems that the only target of the duty -tax policy has been ensuring budget incomes "at any rate" neglecting other targets, this policy must meet. In this sense, we believe that the drafting of fiscal policy is mainly based on short-term interests neglecting its long-term effects in economic or social aspects, aiming maintenance of social development balances. Although it is not the target of this working paper to confirm that the fiscal and duty charge must be reduced by X percent, we believe that it is the time for a more complete revaluation of the fiscal charge in ratio to competitive countries.

The fiscal distinction between residents and non -residents is not believed of any economic usefulness with state budget effects, on the contrary, the harm of image is much more viable of consequences (other than in opposition with other investment laws and international commitments in WTO framework).

In the framework of cooperation and regional integration, fiscal authorities of the region must search for more transparency in the publication of legal systems and fiscal dealings with investments. In this way, it would be easier to evidence policies of "steal from the neighbor" and the inducement of cooperation for the harmonization and forbiddance of discriminating practices.