



Tracking Special Economic Zones in the Western Balkans

Objectives, Features and Key Challenges



Tracking Special Economic Zones in the Western Balkans: Objectives, Features and Key Challenges

This paper is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and the arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

This document has been produced with the financial assistance of the European Union. The opinions expressed and arguments employed herein do not necessarily reflect the official views of the European Union.

Foreword

Foreign direct investment (FDI) can have a positive impact on the growth and development of the recipient economies. In addition to the direct benefit from the injection of new capital into the economy, FDI can also be a source of technology and know-how that can boost the competitiveness of local firms and support their integration into global value chains. Policies aimed at attracting FDI are therefore of crucial relevance for the Western Balkans economies, that have traditionally underperformed in comparison to Central and Eastern Europe during the 1990s, in terms of investment attraction, export promotion and economic growth.

The OECD South East Europe (SEE) Regional Programme supports countries in the region to foster sustainable growth, investment and employment through reforms in favour of competitiveness and private sector development. Among the wide range of investment attraction policies, special economic zones (SEZs) currently play an important role in attracting foreign investors, who can benefit from a wide array of fiscal and regulatory exemptions and facilitations within SEZs' borders. Over the last decade, the economies covered by this study (Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Kosovo,* Montenegro and Serbia) have adopted specific laws establishing SEZs, and their number in the region has grown significantly in recent years.

This report is, to the authors' knowledge, the first attempt to systematically collect in one place the different experiences of these six economies, the specific details of the special economic zones in each of them and how they are being used, in an attempt to answer two basic questions: i) what are the incentives offered in the special economic zones across the Western Balkans?; ii) And what impact have these zones had on FDI levels in the region, and more broadly on the economies under scrutiny?

The report provides a base for future research on the subject that will need to analyse whether SEZs do work as effective and optimal tools for attracting investment into the Western Balkans and contribute to sustainable growth. It also considers the implications of the WB economies' approaching membership of the European Union and the need to eventually harmonise their competition policies, including SEZ strategies, with the Treaty on the Functioning of the European Union.

*This designation is without prejudice to positions on status, and is in line with United Nations Security Council Resolution 1244/99 and the Advisory Opinion of the International Court of Justice on Kosovo's declaration of independence. Hereafter referred to as Kosovo.

Acknowledgements

This study is a product of the work carried out by the OECD South East Europe Regional Programme, part of the OECD Global Relations Secretariat. It was conducted under the umbrella of the project on Economic Reform Programmes in South East Europe.

The lead author of this report is Marija Kuzmanović, Policy Analyst in the OECD South East Europe Regional Programme. Other authors include Haris Avdić Pejičić, Marijana Petrović, Filip Stefanović and Gorazd Režonja, all Policy Analysts in the OECD South East Europe Regional Programme. The report was produced under the overall supervision of Directors for OECD Global Relations: Marcos Bonturi, and Andreas Schaal; and Marzena Kisielewska, Head of Division, OECD South East Europe Regional Programme. The report's lead reviewers were Karim Dahou, Senior Counsellor, OECD Global Relations; Carlos Conde, Head of Division, Middle East and North Africa Regional Programme; and Antonio Fanelli, Senior Advisor, OECD Strategic Partnerships and New Initiatives.

The report is based on extensive desk research as well as fact-finding missions in the Western Balkan region. It benefited from data and insights from the zone administrations, investment agencies, and other relevant public institutions in the Western Balkan economies, as well as from enterprises operating inside the Western Balkan zones. It also benefited from additional review and comments by Ivan Petrushevski and Nikolina Stojanovska, Directorate from Technological and Industrial Zones in the Former Yugoslav Republic of Macedonia; Milan Ristić, Marko Bradić and Vidak Tomić from the Free Zone Authority in Serbia; Mia Marjanović from the Ministry of Foreign Trade and Economic Relations of Bosnia and Herzegovina, and Stipo Djak from the Foreign Investment Promotion Agency of Bosnia and Herzegovina; Faton Bajra from the Kosovo Investment and Enterprise Support Agency; and Genti Beqiri from the Albanian Investment Development Agency.

The report was reviewed and enriched with further inputs from David Bradbury, Giorgia Maffini, Michelle Harding and Kurt Van Dender from the OECD Centre for Tax Policy, Tax Policy and Statistics Division; Przemyslaw Kowalski and Jared Greenville from the OECD Trade and Agriculture Directorate Development Division; Hans Christiansen from the OECD Directorate for Financial Affairs (DAF) Corporate Affairs Division; Stephen Thomsen and Monika Sztajerowska from OECD DAF Investment, and Ruben Maximiano and Sabine Zigelski from OECD DAF Competition.

This report was prepared for publication by Vanessa Vallée and edited by Sally Hinchcliffe.

Table of contents

Acronyms and abbreviations	8
Executive summary	11
Chapter 1 Introduction to special economic zones in the Western Balkans	13
1.1. Special economic zones: Definition and typology	14
1.2. SEZ location, ownership and management.....	14
1.3. Types of Incentives for SEZs	15
1.4. SEZs in the Western Balkan context	17
Chapter 2 Investment context of the Western Balkan economies	19
2.1 Significance of historic context	20
2.2 The evolution of investment in the post-transition period.....	20
2.3 Current competitive position of the WB region	26
Chapter 3 Current Western Balkan special economic zone network	31
3.1 Classification of the special economic zones.....	32
3.2. Zone ownership and management.....	33
3.3 Zone regulation.....	34
3.4 Location of the special economic zones	36
Chapter 4 Zone incentives in the Western Balkan economies	41
4.1. The role of incentives in the Western Balkan special economic zones.....	42
4.2. Zone incentives in Bosnia and Herzegovina.....	43
4.3. Zone incentives in the Former Yugoslav Republic of Macedonia.....	43
4.4. Zone incentives in Serbia	44
4.5. Zone incentives in the EU accession context.....	46
Chapter 5 Direct economic impacts and spillover effects of special economic zones	51
5.1. Direct impact	52
5.2. Spillovers.....	53
Chapter 6 Questions for further analysis	59
Conclusion	62
Annex A: SEZs profiles	65
Albania	66
Bosnia and Herzegovina	68
Former Yugoslav Republic of Macedonia	70
Kosovo	72
Montenegro.....	73
Serbia	75
Annex B: The OECD Policy Framework for Investment	77
Notes	80
References	81

Figures

1.1. The expansion of zones in the Western Balkans, 2006-2015.....	18
2.1. Cumulative net capital flows, 1989-2002.....	21
2.3. Change in unit labour costs (ULC) and components relative to Germany, 2005-2012.....	25
2.4. Unit labour costs, 2014.....	27
2.5. Nominal corporate tax, percentage of net profits, 2016.....	28
2.6. Electricity prices for industrial consumers, excluding VAT and other recoverable taxes and levies (eurocent per Kilowatt-hour, first semester 2016).....	29
3.1. Zone network in the Western Balkan Region.....	37
5.1. Exports of machinery and transport equipment as a percentage of total goods exports, 2005 and 2014.....	53

Tables

1.1. General classification of zone typologies.....	14
1.2. Types of incentives in special economic zones.....	16
2.2. Main automotive manufacturing investments in Central Europe in the 1990s and 2000s.....	24
2.3. Average PISA scores, 2015.....	28
2.4. Competitive state of Western Balkan economies.....	29
3.1. Active zones in the Western Balkan region.....	33
3.2. Zone ownership, regulation and management in the Western Balkans.....	35
3.3. Zone location features by economy.....	39
4.1. Maximum aid intensities allowed in the European Union (% of total investment).....	47
4.2. Tax and non-tax incentives per economy.....	48
5.1. Key indicators for the special economic zones in the Western Balkans.....	52
A.1. Types of incentives in Albania.....	66
A.1. Types of incentives in Albania.....	66
A.2. Special economic zones in Bosnia and Herzegovina (2014).....	68
A.3. Type of incentives (fiscal and non-fiscal) in Bosnia and Herzegovina.....	69
A.4. Special economic zones in the Former Yugoslav Republic of Macedonia.....	70
A.6. Types of incentives in the Former Yugoslav Republic of Macedonia.....	71
A.4. Types of incentives in Kosovo.....	72
A.7. Special economic zones in Montenegro.....	73
A.8. Types of incentives (fiscal and non-fiscal) in Montenegro.....	74
A.9. Special economic zones in Serbia.....	75
A.10. Types of incentives in Serbia.....	76

Boxes

2.1. Investment incentives and special economic zones in Central Europe and the Baltic States.....	22
4.1. OECD Checklist for FDI incentive policies.....	44

Acronyms and abbreviations

ALB	Albania
BGR	Bulgaria
BIH	Bosnia and Herzegovina
EST	Estonia
FBIH	Federation of Bosnia and Herzegovina
HRV	Croatia
HUN	Hungary
KOS	Kosovo
LTU	Lithuania
LVA	Latvia
MKD	Former Yugoslav Republic of Macedonia
MNE	Montenegro
POL	Poland
ROU	Romania
RS	Republika Srpska
SRB	Serbia
SVK	Slovak Republic
SVN	Slovenia
AIDA	Albanian Investment Development Agency
BAM	Bosnian mark
BEEPS	Business Environment and Enterprise Performance Survey
BLA	Bilateral agreement
CEB	Central Europe and the Baltics
CEE	Central and Eastern Europe
CEFTA	Central European Free Trade Agreement
CPC	Commission for the Protection of Competition
CSAC	Commission for State Aid Control
EBRD	European Bank for Reconstruction and Development
EFTA	European Free Trade Association
EPZ	Export-processing zones
FDI	Foreign direct investment
FIPA	Foreign Investment Promotion Agency of Bosnia and Herzegovina
FTA	Free trade agreement
FZA	Serbian Free Zones Administration
GDP	Gross domestic product
GVA	Gross value added
GBER	General Block Exemption Regulation
GVC	Global value chains

IMF	International Monetary Fund
KIESA	Kosovo Investment and Enterprise Support Agency
MoE	Ministry of Economy
MoF	Ministry of Finance
NCTS	New Computerised Transit System
NGO	Non-governmental organisation
NTBs	Non-tariff barriers
NUTS	Nomenclature of Territorial Units for Statistics
OECD	Organisation for Economic Co-operation and Development
OSS	One-stop shop
PISA	Programme for International Student Assessment
PFI	Policy Framework for Investment
PPP	Public private partnership
PSP	Private sector participation
R&D	Research and development
RAS	Serbian Development Agency
RGC	Regional Cooperation Council
RIA	Regulatory impact assessment
RTA	Regional trade agreement
SAA	Stabilisation and Association Agreement
SEE	South East Europe
SEZ	Special economic zones
SOE	State-owned enterprise
SMEs	Small and medium-sized enterprises
STP	Science and Technology Park
TEC	Treaty Establishing the European Community
TFEU	Treaty on the Functioning of the European Union
TIDZ	Technological and Industrial Development Zones in Former Yugoslav Republic of Macedonia
TFA	Trade Facilitation Agreement
ULC	Unit labour cost
VAT	Value added tax
VET	Vocational education and training
WB	Western Balkans
WTO	World Trade Organization

Executive summary

Special economic zones (SEZs) have become a widely used instrument for attracting investment to the Western Balkan (WB) region, and their influence has grown considerably in the post-crisis period. The number of zones has quadrupled over the past eight years as some economies expanded their existing zone networks and others created them for the first time. Zones and their accompanying incentives have also become one of the critical drivers in the intensifying regional competition for foreign direct investment (FDI). The aim of this report is to take a closer look at the main features and trends in the development of zones in the WB region and to raise key questions for further analysis and monitoring on this important topic.

SEZs have developed as part of wider investment strategies aimed at boosting manufacturing investment in the embattled WB economies, which have struggled for decades to reverse the post-transition deindustrialisation and create the foundations for sustainable economic growth. The primary goal of the zones is to attract investment, particularly export-oriented FDI, and create jobs, by providing various fiscal and non-fiscal incentives for zone investors. As a result, across the Western Balkans, zone networks are generally located in strategic investment locations near major cities, transport corridors and national borders. They also tend to be located near industrial centres from the pre-transition period, where they can have access to a sizable workforce with the required technical skills.

Otherwise, zone networks vary considerably in terms of their ownership, management, and the incentives they offer to investors:

- SEZs range from predominantly state-owned and centrally-run in the Former Yugoslav Republic of Macedonia, to decentralised public-private partnerships in Serbia, fully privately owned zones in Bosnia and Herzegovina and Montenegro, and a combination of the two in Albania and Kosovo.

- On the incentive side, the Former Yugoslav Republic of Macedonia offers the widest range of tax- and non-tax incentives to its zone investors, including subsidies, favourable lending conditions, state guarantees and tax relief. In Serbia and Bosnia and Herzegovina, the incentives are largely cash-flow based incentives such as customs and value-added tax (VAT) exemptions, although Serbia, too, offers investors considerable labour subsidies both inside and outside of the zones.

Even though all the WB economies have EU-imposed limits on the amount of state aid they can provide to enterprises, they are less restricted than EU member states on the type of aid they can grant, which may give them advantages in attracting FDI compared to regional EU peers, at least over the short run. Question marks remain, though, over their relative impact compared with other attraction factors –such as physical and human capital– whose development depends on tax bases which can be eroded by incentive schemes.

Evidence from the Former Yugoslav Republic of Macedonia and Serbia, which have the largest networks of active SEZs, suggests that zones are contributing significantly to the recovery of manufacturing FDI. Over the past five years, cumulative zone investment accounted for about 45% of total manufacturing FDI in the Former Yugoslav Republic of Macedonia and around 80% in Serbia, the latter dominated by the sizable Fiat-Chrysler investment in a car manufacturing plant in 2012. As in Central and Eastern Europe in the

early 1990s, it is the automotive sector that is leading the revival of manufacturing FDI in the WB SEZs. Over 90% of zone investment has been in labour-intensive automotive manufacturing ranging from manufacturing small automotive parts to the assembly of final vehicles. Automotive manufacturers are attracted by the region's strong industrial past, cheap skilled labour, and proximity to the EU market, in addition to the zones' very attractive incentives for export-oriented manufacturers, which reduce the cost of doing business in these economies.

Since their establishment, SEZs in the WB region have attracted almost 400 foreign companies and a cumulative investment of over EUR 2.5 billion. Companies active in the special economic zones have generated more than 22 000 jobs in Serbia, 6 800 in the Former Yugoslav Republic of Macedonia and about 1 700 in Bosnia and Herzegovina thus far. Even though zone investments are relatively recent (most less than a decade old), some preliminary anecdotal evidence suggests that the zones have had a number of positive spill-overs in education, training and infrastructure. On the other hand, they have so far had a limited impact on the transfer of technology to domestic producers and the integration of local suppliers into the business operations of foreign investors.

In light of their growing importance as a policy instrument, the zones warrant a closer and more critical inspection. This kind of analysis is beyond the scope of this study, but the report does raise some critical questions for further examination. Most importantly, the report:

- Highlights the significance of conducting a more thorough assessment of the impact and effectiveness of the zones in attracting sustainable FDI that can not only bring jobs but can spur on structural transformation of the economy through backward linkages and technological transfer;
- Notes the need to weigh the economic benefits of SEZs against the considerable (notably fiscal) costs entailed in the development and maintenance of the zones and their incentives; and
- Calls for a platform for regional dialogue on SEZs in light of the considerable negative consequences that can arise from a potential incentive race to the bottom.

Chapter 1

Introduction to special economic zones in the Western Balkans

This chapter introduces the concept of special economic zones and their key features for audiences that may not be familiar with this policy instrument. Section one focuses on the classification of SEZs based on development objectives, location and types of activities entailed. Section two describes the key locational features of SEZs and how they vary based on development objectives, and then goes on to explain the different types of management and ownership modalities that SEZs can take. Last but not least, the chapter introduces the zones in the Western Balkan context and the main motivations for the writing of this report.

1.1. Special economic zones: Definition and typology

Special economic zones (also referred to as free zones) represent designated geographical areas within an economy, where business activity is subject to different rules from those prevailing in the rest of the economy. Those rules can pertain to investment conditions, trade, customs and taxes, etc. (Farole, 2011a).

Zones can be established with different policy goals. The most common objective around the world is to attract foreign direct investment (FDI), as a means of boosting exports, links to global value chains (GVCs) and/or structural transformation of the economy. In countries suffering from high levels of unemployment, zones have been used to boost job creation by attracting investment in highly labour-intensive industries (for example in the Dominican Republic and Tunisia). Last but not least, zones have also been created to support wider economic reforms such as export diversification and upgrading (for example in the People's Republic of China, Korea and Chinese Taipei) as well as to serve as laboratories for experimentation with new policies and approaches that could, if the outcomes are satisfactory, be scaled up to the entire economy (for example in the People's Republic of China) (FIAS, 2008).

There is no single and universally accepted classification of special economic zones, but the commonest approaches group them according to key factors such as their development objectives, their location and the types of activities they house. This report uses the World Bank's classification (Table 1.1), which defines six different types of zones ranging from free trade zones, which focus largely on trade facilitation, to export-processing zones (EPZs) which seek to boost exports, and enterprise zones, targeting broader regional development (FIAS, 2008).

Table 1.1 General classification of zone typologies¹

Type of zone	Development objective	Description	Markets
Free trade zone	Supporting trade	Also known as commercial free zones, these are clearly delimited areas (fenced-in, duty-free), offering warehousing, storage and other services aimed at boosting import-export.	Domestic, re-export
Export processing zones (EPZs)	Export and manufacturing	Industrial clusters offering incentives and facilitation of manufacturing and other activities prevalently export-oriented.	Mostly export
Hybrid EPZs	Export and manufacturing	Sub-divided zones with one part open to all industries regardless of their export orientation, and another specifically designed for export-oriented firms.	Export and domestic market
Freeport	Integrated development	Large territories accommodating all types of activities, providing broad incentives and benefits. Can also include residents on the site.	Domestic, internal and export markets
Enterprise zones	Urban revitalisation	Aimed at revitalising distressed urban and rural areas, enterprise zones mostly flourish in developed countries and are characterised by the provision of tax incentives and financial grants.	Domestic
Single factory EPZ	Export manufacturing	Incentives are provided to a specific enterprise, rather than to a geographic location.	Export market

Note: This report does not cover industrial and technology parks because SEZs under our definition require provision of a specific regulatory framework and/or incentives regime restricted to the enterprises operating on the pre-defined zone territory.

Source: Derived from FIAS (2008), *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development*, World Bank.

1.2 SEZ location, ownership and management

The location of zones varies depending on the purpose for which they were created. Zones intended to attract investment and foster industrial activity in a particular geographical region tend to be located near major transport corridors (including ports and airports), large cities, near universities or relevant vocational schools, or in locations of former or existing industrial activity. However, if the primary role of the zones is to foster economic activity in underdeveloped regions of the economy, then they might be sited in more remote and less well connected areas. In those cases, the zones will be part of a broader regional development agenda that is generally accompanied by investments

in additional infrastructure, the establishment of relevant educational and training programmes and so on.

Zones can have different forms of ownership. In publicly owned and operated zones, the government takes on the role of developer, operator and regulator of the zones, whereas in privately owned zones, companies develop, manage and operate the zones under the government's regulatory oversight. Zones can also operate as public-private partnerships (PPPs), whereby the government takes part in the zone development and operation in order to encourage private sector participation in this project. This government support can take the form of initial zone development, which the government then leases or contracts out to private operators to manage the provision of on- and off-site infrastructure (such as utilities or connection roads) or the provision of additional services such as establishing zone-specific customs terminals (FIAS, 2008).

For publicly owned zones, the level of centralisation of ownership and management can also vary. In a centralised system, a designated central government agency has the sole mandate and responsibility for developing and managing all the economic zones in that economy. In a decentralised system, local government authorities are given the responsibility for zone development and management, in the hope that they will be more familiar with local market conditions and can perhaps react more quickly and accurately to the needs of zone investors (Farole and Kweka, 2011). However, even in decentralised systems, a central government body (zone administrator) is in place to co-ordinate zone activities (such as investment promotion), facilitate central government services (such as licensing, land use, utilities provision etc.), co-ordinate with other government bodies (such as customs and tax administration) and monitor regulatory compliance, including EU state aid rules.

1.3. Types of Incentives for SEZs

One of the critical features distinguishing SEZs from the rest of the economy is the distinct incentives they offer to companies operating in the zone territory. These incentives are generally grouped into two broad categories: tax and non-tax incentives (Table 1.2).

Tax incentives are attractive for investors because they reduce their tax liabilities. These incentives can take a number of forms, including tax holidays, which exempt investors from paying corporate income or other taxes, and capital cost allowances, whereby investors receive benefits related to their capital investments (see Table 1.2. for more detail). The tax incentives are usually extended with a sunset provision that defines an expiry date for the specified incentives. Ideally these sunset clauses should be strictly adhered to in order to ensure that investors do not have unlimited access to preferential treatment under the zones. If they are re-negotiated, this is clearly justified and in line with contingencies specified under the sunset clause; the continuation of such incentives is usually conditional on the positive evaluation of past effects (Owens, 2005).

Non-tax incentives can be quite wide-ranging from streamlined administrative procedures, such as one-stop shops for government services and fast-track customs procedures, to the provision of infrastructure, or simplified legal and regulatory requirements. These additional services can be just as important as tax incentives in attracting investment into a zone, but their impact depends on the circumstances and the types of tax incentives on offer: different types of zone (and thus, the kind of incentives provided) are more suitable for some countries than others, mainly due to each country's overall socio-economic context and its stage of development (Farole, 2011b).

In countries with limited appeal for foreign investors it has been argued that zones are able to largely neutralise the effects of an otherwise adverse investment climate by providing better facilities, additional services and best practice policies (FIAS, 2008). Indeed, faster administrative procedures in zones may act as a pull factor in countries

where such procedures are lengthy and costly. Similarly, the additional infrastructure provided in the zone (ranging from high-speed telecommunications and Internet services to medical and day care facilities) may also give zones a relative advantage, particularly in countries where investors regularly face infrastructure-related obstacles (such as periodic black outs, overall low Internet connection speeds or absence of broadband connection, etc.). The same can be argued for countries with cumbersome and drawn out customs procedures, where the existence of an ad hoc customs terminal (and the streamlining and speeding up of procedures this entails) may act as a useful draw for companies.

Table 1.2 Types of incentives in special economic zones

Tax and other financial incentives
<p>1. Corporate tax incentives</p> <p>Tax holidays exempt firms from corporate income tax, and possibly other taxes, for a specified number of years. Tax holidays can be relatively simple to administer and benefit the affected companies in the short run, as they have the option to terminate the relevant business activities at the end of the tax holiday. On the other hand, tax holidays may be problematic particularly if they target sectors or activities, raising the question of the treatment of firms already engaged in that sector or activity or in other sectors or activities that do not qualify. Tax holidays are generally least attractive to firms in sectors that require long-term capital commitments and that cannot realise immediate profits (OECD, 2001: p.26).</p> <p>Targeted (or broad based) reductions in the statutory corporate income tax rate reduce the amount of tax the economy (or zone, if done in the context of a zone) levies on targeted (or broadly defined) taxable profits. This measure is relatively simple to administer and revenue losses are more transparent. As with tax holidays, targeting such measures at income from a subset of activities or investors can be problematic as it can cause tax avoidance and revenue leakage. Statutory corporate tax reduction invites tax avoidance through high-tax enterprises shifting profits to low-tax ones via transfer pricing (intra-country and international) (OECD, 2001: p.26).</p> <p>Capital cost allowances include 1) accelerated and enhanced write-offs for qualifying capital costs; and 2) general or targeted investment tax credits. Accelerated write-offs lower the amount of taxable profits, while investment tax credits provide a straight reduction to the amount of corporate tax otherwise payable. In the case of the former, a specific percentage is deducted directly from taxable income; therefore it also depends on the value of the corporate income tax rate. On the other hand, the value of the corporate tax does have an impact on the value of the investment tax credit (OECD, 2001: p.27). The advantage of the capital cost allowances is that the revenue cost is directly related to the amount of the investment, so there is no need for minimum eligibility thresholds. Capital cost allowances tend to favour capital-intensive investment and may be less favourable towards employment creation than tax holidays (Easson and Zolt, 2002: p. 20).</p> <p>Financing incentives such as dividend withholding tax rate reductions and imputation relief, provide an offset to corporate tax on distributed profit. In certain cases they may lower the discount rate applied by foreign investors to after-tax cash flows from FDI. The impact of such an investment will depend on the sources of financing. For example, dividend withholding tax rate reductions will lower the cost of funds if new shares are a marginal source of financing (OECD, 2001: p.28).</p> <p>2. Custom duties exemptions</p> <p>Customs duties are taxes collected on imports of raw materials, components and capital goods (and sometimes on exports) by the customs authorities. They are based on the value of goods (<i>ad valorem</i> duty) or on the weight, dimensions or other criteria of the items.</p> <p>Exemptions on customs duties for capital goods can be particularly relevant for investors, as the taxes collected on capital goods cannot be as easily recovered as those on raw materials and components, so they can substantially raise the initial cost of investment. According to the Easson and Zolt (2002: p.23), “many investors consider this type of incentives to be the most valuable type of investment incentive”. Furthermore, this type of incentive is independent of profitability (“up-front benefit”) which means investors receive an immediate saving (Easson, 2004).</p> <p>The drawback to incentives of this type is that they encourage imports over local sourcing. Some countries, such as the Czech Republic, Pakistan and Taiwan stipulate that the exemption applies only to goods that are not available locally. There is also a risk that goods imported free of duty will subsequently be sold on the domestic market, rather than being used for production purposes. In such cases, readily saleable products such as automobiles should be excluded from any exemptions (Easson, 2004). According to Easson and Zolt (2002), granting such an exemption on a selective basis can be in violation of international trade rules.</p> <p>3. Value-added tax refunds</p> <p>A value-added tax (VAT) is a consumption tax that can be introduced at any stage in production or final sale when value is added to the product. In many specific cases, VAT can be claimed back by the tax-payer on a later stage. Most countries that grant custom duty exemptions also exempt investors from import VAT on the same items. While such exemptions are costless, they generally do not constitute a major benefit to the importer, apart from cash-flow benefits (Easson, 2004).</p> <p>4. Property tax exemption/reduction</p> <p>A property tax is a tax applied to real estate property, and is usually collected by local or municipal administrations. The advantage of property tax exemptions or reductions is that their costs are fully predictable, while normally being limited in duration. Property tax incentives generally fall under regional development policies and are often granted by the same local government authorities that assess them in the first place (Easson and Zolt, 2002: p. 23).</p> <p>5. Personal income tax and social security reductions</p> <p>Some economies use reductions in personal income taxes and social security contributions as an incentive to invest in regions of high unemployment. Their impact is likely to be moderate if personal taxes and social security contributions constitute a large part of the cost of employment. Nevertheless, they are relatively easy to administer. While such incentives add to the overall perception of a favourable investment environment, they are not very likely to play an important role for investors (Easson and Zolt, 2002: p. 23).</p> <p>6. Subsidies</p> <p>Subsidies can include indirect subsidies, like special grants for education and training and direct subsidies like the supply of water and electricity below markets rates (OECD, 2006: p.17).</p>

Table 1.2 Types of incentives in special economic zones (cont.)

Non tax incentives
<p>1. Streamlined administrative services</p> <p>Such services include provision of a single window or one-stop shop for government services, fast-track customs services, simplified license procedures, and, potentially, dedicated legal frameworks and courts (OECD, 2006: p.17).</p>
<p>2. Relaxed legal and regulatory requirement</p> <p>In some cases, zones can relax legal and regulatory requirements, including those concerning foreign ownership, labour and environmental laws and regulations, foreign exchange regimes, rules on the lease and purchase of land, most favoured nations status, and land lease under preferential terms (OECD, 2006: p. 17).</p>
<p>3. Export promotion services</p> <p>Export promotion services include business advice, sales and marketing support, finance, and export credit services (OECD, 2006, p. 17).</p>
<p>4. Infrastructure</p> <p>While the offsite infrastructure, such as roads, railroads, airport and seaports and access to energy, is highly relevant, the economic zones normally have more influence on the on-site infrastructure, which include training facilities, common bonded warehouse facilities, business services facilities, on-site banking facilities, on-site customs clearance and trade logistics facilities, high-speed telecommunications and internet services, and more (FIAS, 2006: p.17).</p> <p>Such on-site infrastructure is often part of more general regional development policies and resources for it can often be granted by local, rather than central, government authorities.</p>

1.4. SEZs in the Western Balkan context

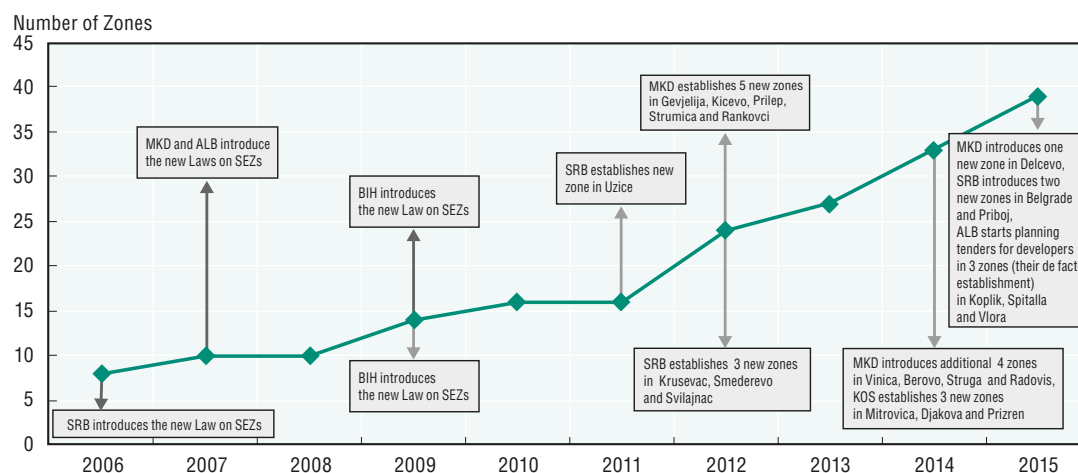
The six Western Balkan (WB) economies, which this report focuses on - Albania, Bosnia and Herzegovina, Kosovo, the Former Yugoslav Republic of Macedonia, Montenegro and Serbia - have developed a large network of zones that now spans all six economies and encompasses an area of more than 3 000 hectares. The rapid rise and expansion of the zones came in the wake of a post-crisis slump which prompted the re-orientation of the economies toward more export-driven growth models fuelled by investment, particularly FDI. The zones were therefore designed with the primary aim of attracting FDI, particularly in the manufacturing sector, boosting job creation and fostering structural transformation into higher valued added, largely manufacturing, activities.

The Former Yugoslav Republic of Macedonia and Serbia pioneered this policy instrument in the region in the post-crisis period, and their success in attracting significant new manufacturing investment in the zones has not only prompted the expansion of the existing zone network but also the establishment of new zones.² Albania and Kosovo, for example, have recently introduced new zone legislation and are now in the process of establishing economic zones on their territories. As a result, the number of zones has almost doubled over the past four years, from 24 in 2012 to 39 in 2016 (Figure 1.1).

This growing interest in the special economic zones warrants a closer and more critical look at this policy instrument in the region. Are the zones effective at boosting FDI and growth? Is this investment sustainable? How does the positive impact from the zones measure up against the cost of sustaining them? And could the intensifying regional competition for FDI potentially lead to a detrimental race to the bottom for all the regional economies?

One of the key goals of this report is to prompt more thinking and discussion on these topics at a regional level. It attempts to start this discussion by providing a detailed overview of the current situation with special economic zones in the region, and then, outlining key questions for further study and examination in order to inform investment-related policy making in the region.

Figure 1.1 The expansion of zones in the Western Balkans, 2006-2015



Source: Data from zone authorities compiled by the OECD

This report consists of the following further chapters:

Chapter 2 sheds light on the general investment climate in the Western Balkans and the role that zones play in this context. It provides an overview of the investment landscape in the post-transition period and explains the difficulties Western Balkan economies have faced in attracting FDI. It then goes on to review key investment climate and competitiveness indicators and sheds light on the general competitive position of the Western Balkan economies that is driving FDI inflows inside the zones today.

Chapter 3 looks more closely into the current economic zone network in the Western Balkans, their location, size, development objectives, eligibility criteria and market-orientation. It also looks at the management structure, ownership and regulatory oversight of the zones in each economy.

Chapter 4 provides a detailed overview of the fiscal and non-fiscal incentives that the zones in each economy provide. It, therefore, covers not only the incentives that directly affect the cash-flow of enterprises in the zone but also the numerous services the zones offer, which indirectly affect the enterprises' bottom line.

Chapter 5 looks at the economic impact of the zones and main spillover effects that have been noted so far, including their contribution to investment, manufacturing and exports, as well as evidence of technology transfer, skill development and backward and forward linkages with the local economy.

Chapter 6 looks into key topics requiring further research which can shed light on the impact of the zones in each economy.

The **Conclusion** summarises the key messages of the report.

Chapter 2

Investment context of the Western Balkan economies

This chapter provides the historic background and investment context behind the development of special economic zones (SEZs) in the WB region. It consists of two sections. The first looks at the evolution of investment in the Western Balkan region since the early 1990s, explaining the challenges that the WB economies faced in attracting FDI, particularly in the manufacturing sector in comparison with peers in Central Europe and the Baltics (CEB). This section focuses on the automotive industry, which was one of the key drivers of manufacturing FDI inflows especially in Central Europe throughout the 1990s and early 2000s and is now shaping FDI in the WB region. It also explains how the CEB economies used economic zones and incentives to attract FDI in the early 1990s.

The second section provides a brief overview of the current investment climate in the Western Balkans in order to shed light on the policy environment in which the economic zones are operating or being introduced. The zones have become an important vehicle for attracting investment in this region also due to the fact that they remove important obstacles that still persist in the rest of the economy. So before the report delves into mapping out and describing the different zones, it is important to highlight the main drivers of investment in the region and the constraints to investment that zones are trying to resolve.

2.1 Significance of historic context

Despite having opened up their economies to trade and investment in the late 1990s and early 2000s, the Western Balkan economies have struggled to attract investment during the past twenty years of economic transition. In comparison to regional peers from CEB, the WB economies have received considerably lower cumulative capital inflows as well as lower foreign direct investment (FDI).³ This investment gap was particularly pronounced for manufacturing FDI throughout the 1990s and early 2000s and this chapter will explain in more detail what can account for these trends.

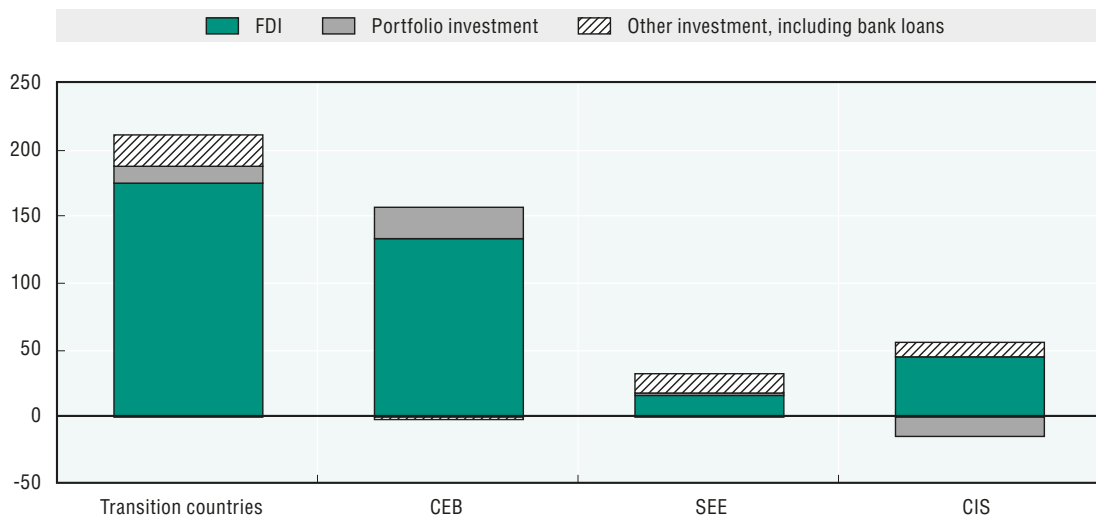
Understanding the historical investment context of the region serves two important purposes. First, the widely different investment dynamics are one of the key reasons why the growth and convergence trajectories of the CEB and the WB regions have been so different in the post-transition period. They explain not only why the WB economies have only recently begun to attract notable FDI in the manufacturing sector, but also why they pursue this investment with such intensity and through sometimes quite aggressive incentive policies inside the special economic zones. Second, the investment dynamics in the current WB zone networks bear close resemblance to those of the CEB economies in the early transition period, and, therefore, many interesting parallels can be drawn between the historical experience of the CEB region and the WB economies today.

2.2 The evolution of investment in the post-transition period

It can be argued that the 1990s were critical in defining the divergent growth and investment paths of the WB and CEB regions. In the CEB states, this period was marked by economic growth and considerable economic restructuring accompanied by large capital inflows, especially in the form of FDI. For the WB economies, the 1990s can best be a lost decade, as the region remained mired in a deep political and economic crisis caused by the prolonged armed conflict that accompanied the break-up of Yugoslavia, coupled with external embargoes and sanctions, double digit negative growth rates, rampant inflation, highly volatile and depreciating exchange rates and non-market oriented policies. As a result, the 1990s in the WB were accompanied by deep recession.⁴ Real gross domestic product (GDP) declined by 50% in Bosnia and Herzegovina and the Federal Republic of Yugoslavia - consisting of what is today Serbia, Montenegro and Kosovo - and by 25% in the Former Yugoslav Republic of Macedonia. The region also saw slow progress on structural reforms and very limited domestic and foreign investment (EBRD, 2003).

The investment gap between the CEB and WB regions was particularly pronounced over this period. Between 1989 and 2002, the CEB countries received over EUR 150 billion of net capital inflows while the WB received less than EUR 20 billion. The difference in per capita terms is somewhat smaller, but the CEB region still accounted for roughly five times as much capital intake as the WB region (Figure 2.1). In the CEB region, FDI comprised roughly 80% of total capital inflows, and was mainly directed at manufacturing and general industry (40% of total FDI), followed by financial intermediation and trade. In the WB region, meanwhile, FDI accounted for only about 50% of total capital inflows, and went largely into trade and financial intermediation (EBRD, 2003).

Figure 2.1 Cumulative net capital flows, 1989-2002
(billions of USD)



Source: EBRD (2003), Transition Report 2003: Integration and Regional Cooperation

Most of the early manufacturing FDI receipts in the CEB region were driven by privatisations in the electronics; food and beverages; oil, gas and mining; and automotive sectors (EBRD 1994). As restrictions on investment into the telecommunication and financial services sectors were lifted, these too became important sources of FDI, especially in the second half of the decade. In the WB region during this period, FDI also entailed the first wave of large privatisations, but most of these privatisations related to services. Moreover, actual FDI receipts were small, not only because just a few foreign enterprises ventured in the region at this time, but also because these privatisations fetched very low prices due to the higher risk premiums associated with investment in these economies at that time (EBRD, 2003; OECD, 2003a).

What explains this large discrepancy in FDI during the 1990s? A study conducted by the European Bank for Reconstruction and Development (EBRD) in 2003 noted that early FDI in the transition region was characterised by market- and efficiency-seeking motives (EBRD, 2003). “Market seeking” means that firms were attracted by the size of the market and the growth potential of the regional economies and, thus, characterised investments in the domestically oriented service sectors such as financial intermediation, telecommunications, retail and real estate. “Efficiency seeking” means investments that sought to take advantage of cheaper labour, infrastructure or other inputs, in order to achieve efficiency gains, and these largely referred to investments in the tradable sectors, notably the automotive industry.

In both areas the CEB economies had important advantages over the WB economies. They benefited primarily from greater political stability, particularly the lack of (nearby) conflict and/or sanctions; higher-quality institutions due to their more aggressive pursuit of structural reforms; and their relatively brighter prospects for EU accession. Other important drivers of FDI in the CEB region included their low unit labour cost (i.e. the total labour cost to real output ratio), their proximity to the EU market, and the introduction of various incentives for FDI through special economic zones (Box 2.1).

Box 2.1 Investment incentives and special economic zones in Central Europe and the Baltic States

There are many interesting parallels that can be drawn between the investment policies and patterns of the CEB economies in the 1990s and the recent developments in the Western Balkan economies. Throughout the 1990s, CEB countries implemented sweeping structural reforms in an effort to build fully functional market economies. These reforms varied from market liberalisation (deregulation of prices and liberalisation of trade and financial markets) to complex institutional restructuring in the areas of governance, competition policy, labour markets, privatisation and enterprise restructuring.

The large influx of FDI that accompanied the market opening of the CEB economies throughout the 1990s can be attributed in large part to this strong reform orientation and the resulting bright prospects for EU accession. Other important drivers included their proximity and connectivity to the EU market and their low-cost skilled labour force. The economies' relative similarity in these areas did not really present a challenge to the attraction of market-seeking FDI but it did create considerable intra-regional competition for efficiency-seeking FDI, particularly in the manufacturing sector. In light of the intensifying regional competition for FDI, the CEB countries, much like the WB economies today, embarked on an incentive policy agenda that in most countries included the introduction of special economic zones.

From the mid-1990s, most CEB economies began implementing various incentives to encourage greenfield FDI, as well as to intensify cross-border mergers and acquisitions in the private sector. Such incentives came primary in the form of tax holidays and reduced corporate income tax (CIT) rates, but also included exemptions from customs duties, investment tax credit and allowances (Table 2.1).

Hungary was the first to grant generous tax incentives to its large investors, varying from partial to complete corporate tax reductions, the latter if the investment was made in a less developed region. Poland followed suit by introducing special economic zones as a place-based policy offering additional incentives – primarily in the form of a very generous tax holiday. Enterprises investing in the zones were exempted from paying corporate taxes for the first decade of their establishment, and could be granted a 50% reduction in the corporate tax rate for the following ten years (OECD, 2003b).

Table 2.1 Fiscal incentives available in transition countries (2001)

	Hungary	Poland	Czech Republic	Slovak Republic	Estonia ¹	Latvia	Lithuania	Slovenia
Tax holidays	x							
Partial profit exemption	x		x	x	na			
Preferential CIT rate				x	na			x ²
Accelerated depreciation	x				na			
Investment allowance			x		na			
Reinvestment allowance					na			
Investment tax credit	x			x	na	x		
Customs duty exemption			x	x	na	x	x	
Customs duty deferral					na			
VAT exemption								
VAT deferral			x					
Special zones offering:				na	na			
› customs duty exemption	x							x
› VAT exemption								x
› tax holiday (CIT exemption)						x	x	
› investment allowance								x
› investment tax credit		x						
› other tax exemptions						x		x

Note: Table reports incentives available for new investment (ignoring "grandfathering" provisions).

1. As Estonia no longer imposes a corporate income tax (but instead a distribution tax), nor customs duties, tax incentives related to these do not apply.

2: Partial CIT exemption conditional on investment expenditure.

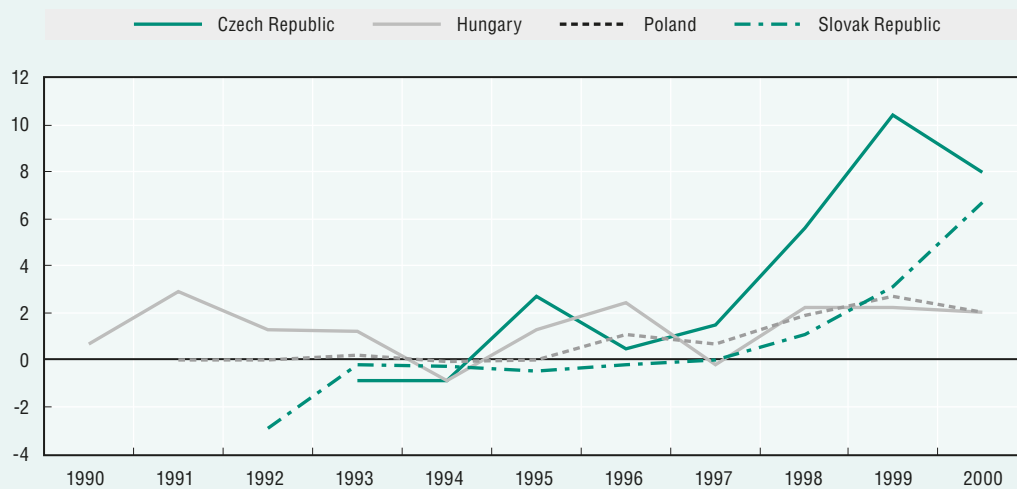
Box 2.1 Investment incentives and special economic zones in Central Europe and the Baltic States (cont.)

Hungary and Poland's example triggered a pattern repeated across the region: in 1997, the Czech Republic introduced generous tax holidays to large investors and additional investor-friendly policies. Slovak Republic also proposed a fiscal aid programme in 1998 including ten-year tax holidays for investments over EUR 4.5 million, direct grants for job creation and training, and generous exemptions from customs duties and special arrangements for construction material and the import of machinery.

Investors in special economic zones were given additional incentives in most economies. In Hungary, foreign enterprises located in special economic zones were allowed to obtain additional tax preferences, as well as grants from the Investment Promotion Fund if the project was primarily of a technological nature. The Czech Republic offered benefits similar to those proposed by Hungary. In Poland, Latvia and Lithuania, only investors located in the zones were able to benefit from tax holidays.

While the zones played an important role in attracting FDI, their specific impact varied depending on the country in question. Poland saw a considerable boost in investment after introducing its zone system, which is arguably why it negotiated to maintain its zone incentives even after joining the EU. In the Czech and Slovak Republics, the introduction of general incentives at the national level had a more important impact on FDI inflow compared to the zone-specific policies (see Figure 2.2). For instance, in 2001 the Czech Republic used a combination of transparent and generous incentives for large investors to attract one of the region's most important greenfield investments to date: the EUR 1.5 billion TPCA car assembly plant in Kolin, which has assembled on average 300 000 cars per year for Toyota and PSA Peugeot-Citroën (EBRD, 2002).

Figure 2.2 Impact of investment incentives on FDI inflows for selected countries, net FDI inflows (Net FDI inflows excluding privatisation revenues as a percentage of GDP)



Source: EBRD Transition Report, 2001

Box 2.1 Investment incentives and special economic zones in Central Europe and the Baltic States (cont.)

Most of the CEB economies had to revise their incentive schemes in the run up to the EU accession in order to comply with EU state aid rules and thus limit the distortive effects on competition and trade within the common market that the former may have entailed. As a result, Hungary had to change its duty-free zone regime in line with EU customs rules, and Latvia and Lithuania had to amend some parts of their laws on SEZs. The Polish Law on SEZs remained the most problematic case, though, mainly due to the lack of provisions on the maximum amount of state aid that could be offered to enterprises entering the SEZs. This was seen as a direct threat to fair competition in the common market, since it could be interpreted as a sustained form of operating (rather than initial) aid by the Polish authorities to the enterprises that chose to settle in the SEZs (Kisłowska, 2006). Upon joining the EU, Poland was able to retain the right to have special economic zones but had to adopt the EU limits on the state aid that can be granted to SEZ enterprises.

As the Western Balkan economies begin to negotiate the relevant chapters of the EU accession treaty, they, too, will have to ensure that all incentives and investment policies are fully compliant with EU rules.

Sources: OECD (2003b) Tax Policy Assessment and Design in Support of Direct Investment: A Study of Countries in South East Europe, www.OECD.org/turkey/34466352.pdf; Appel (2011), Tax Politics in Eastern Europe: Globalization, Regional Integration, and the Democratic Compromise; EBRD (2003) Transition Report 2003: Integration and Regional Cooperation; EBRD (2001), Transition Report 2001: Energy in Transition; EBRD (1994), Transition Report: October 1994.

Industry dynamics also played a critical role in shaping FDI, especially in the tradable sector. The 1990s were characterised by considerable decentralisation of manufacturing and the creation of so-called global value chains (GVCs). The CEB countries, like many emerging markets in Asia and Latin America, saw a considerable influx of FDI as large multinational corporations sought cheaper locations for the manufacturing of product components and the assembly of final products (Sturgeon and Florida, 2000).

These trends were particularly notable in the automotive industry which brought in a tremendous amount of manufacturing investment particularly in Central Europe. By the beginning of the new millennium, investment in the automotive industry reached 23% and 15% of gross fixed investment in Hungary and Slovak Republic respectively (Radosevic and Rozeik, 2005). The need for just-in-time delivery, which characterises this industry, made the region particularly attractive for car manufacturers due to its proximity to Western Europe.⁵ Thus over the 1990s and early 2000s, automotive manufacturers opened a large number of car assembly plants and, consequently, a lot of the automotive component manufacturing also shifted to this part of the world. Investors included not only European, but also Asian car manufacturers, which saw an opportunity to get closer to the EU market at a relatively low cost (Table 2.2). As a result of these investments, the region became a major car manufacturing hub, and for a few of these economies (for example the Czech and Slovak Republics) the automotive sector became the largest domestic industry in terms of value added.

Table 2.2 Main automotive manufacturing investments in Central Europe in the 1990s and 2000s

Country	Investor	Start date	Type of investment	Investment value
Czech Republic	Volkswagen/Škoda	1991	Brownfield	circa USD 5 billion
	TPCA	2002	Greenfield	circa EUR 1.3 billion
	Hyundai	2006	Greenfield	circa EUR 1 billion
Hungary	Suzuki	1992	Greenfield	USD 260 million (by 1997)
	Audi (Volkswagen)	1992	Greenfield	DM 1.3 billion (until 2000)
Poland	Fiat	1991	Brownfield	USD 2 billion (by end of 2000)
	Volkswagen	1993	Brownfield	EUR 600 million (by 2006)
	Daewoo/FSO	1996	Brownfield	USD 1.1 billion
	Opel (GM)	1998	Greenfield	EUR 600 million
Slovak Republic	Volkswagen	1991	Brownfield	EUR 1.5 billion (by 2007)
	Peugeot Citroën	2003	Greenfield	circa EUR 1 billion
	Kia	2004	Greenfield	circa EUR 1 billion

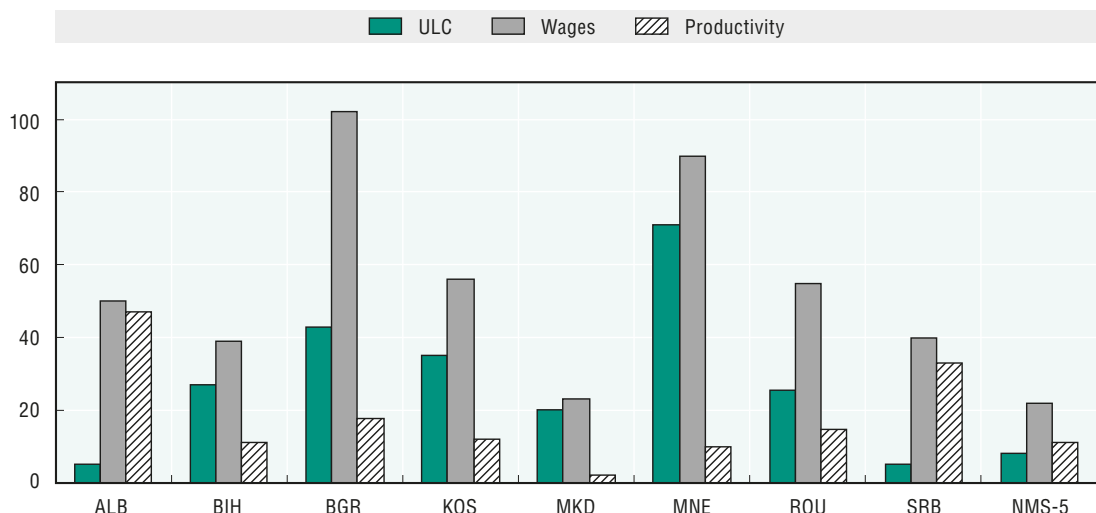
Source: Jakubiak et al. (2008), "The automotive industry in the Slovak Republic: Recent developments and impact on growth".

Despite their considerable automotive industry history, the Western Balkan economies did not benefit at all from these trends in 1990s. The sanctions regime on the Federal Republic of Yugoslavia (today Serbia, Montenegro and Kosovo) between 1992 and 1996, which was then reinstated again in 1998 and finally removed in January 2001, would have put investment in the Zastava plant in Kragujevac, for instance, out of any consideration. The 19-month long Greek embargo on the Former Yugoslav Republic of Macedonia (in 1994-1995) also had considerable impact not only on the country's immediate economic performance but also on its attractiveness as investment destination. The region's weaker cost-competitiveness and delayed onset of the transition also contributed to its relative marginalisation from the developments of the automotive industry in this period (Radosevic and Rozeik, 2005).

Manufacturing FDI also remained fairly limited through most of the 2000s, as the region's competitive position remained weak or, in some cases, weakened even further. Even though FDI increased notably in the run up to the global financial crisis, the vast majority of it went into the non-tradable sector i.e. market-seeking financial intermediation, utilities and retail. Resource-seeking manufacturing FDI was limited to only 10-15% of total FDI and related mainly to privatisations of commodity based industries (such as mines, metals and oil)⁶ (EBRD, 2010).

The entry of Western European banks into the WB markets and the resulting abundant cheap credit fuelled a consumption boom, which accounted for most of the GDP growth in the pre-crisis period, but had a generally unfavourable effect on the external competitiveness of these economies. The capital inflows prompted a rise in wages which was not matched by increases in productivity, resulting in a weakening of external labour cost competitiveness (Figure 2.3). Fixed or managed exchange rate regimes⁷ against the euro prevented any downward adjustment of the exchange rate to counter this decline in competitiveness. Last but not least, credit-fuelled consumption-driven growth arguably acted as a disincentive for more aggressive pursuit of economic reforms, which had implications for the closing of the competitiveness gap with respect to more advanced EU and CEB economies (IMF, 2016).

Figure 2.3 Change in unit labour costs (ULC) and components relative to Germany, 2005-2012
(per cent change)



Note: Data for Bulgaria and Romania are only available for the period 2006-12 (for ULC and productivity) and for 2006-11 for wages Sources:

Sources: Source for all countries with the exception of Bulgaria and Romania: wiiw Annual Database 2016 (2016), <http://data.wiiw.ac.at/annual-database.html>. Source for Bulgaria and Romania: OECD calculations based on Eurostat data (2016b), "Labour costs annual data".

The global financial crisis, which hit the Western Balkans in 2009, revealed the shortcomings of the region's pre-crisis growth model. As cheap credit dried out, the economies of the Western Balkans struggled to find alternative sources of growth. Attracting investment, particularly in the productive sectors of the economy, became even more challenging due to the unfavourable external environment (i.e. the global credit crunch and the economic crisis in the main source economies) and the region's weakened external competitive position. In the immediate aftermath of the crisis, between 2009 and 2012, regional GDP grew by a mere 0.5% and FDI comprised a mere 5% of GDP (IMF, 2016).

The crisis therefore brought a new urgency to the implementation of structural reforms to underpin strong and sustainable economic growth. The need to increase the export orientation of WB economies became widely apparent as did the related need to improve productivity and external competitiveness. This gave way to a reform agenda that focused even more on strengthening the investment climate to boost productive domestic and foreign investment and to support the growth of domestic small and medium-sized enterprises (SMEs), and it was in this context that most of the economies developed their existing special economic zone policies.

2.3 Current competitive position of the WB region

The special economic zone policies in the WB region were not created in a policy vacuum in isolation from wider policies for improving the overall business environment. Over the past two decades, the WB economies have made considerable strides in improving their investment climate by increasing their openness to trade and investment, strengthening the rule of law, creating a more even playing field for all investors, and implementing reforms to strengthen the quality of human capital (EBRD Transition Indicators 2014; OECD, 2010, 2016)

Strengthening investment policy and promotion gained further momentum in the post-crisis period as many economies, most notably the Former Yugoslav Republic of Macedonia and Serbia, began to pursue FDI more aggressively, particularly in the manufacturing sector. Given the regional economies' relative similarity in endowments, competition to attract FDI was another important impetus to both implement structural reforms and to introduce different incentive schemes under the zone regimes. Table 2.3 below provides a more detailed overview of the key features of investment policy in the WB economies and Chapter 4 examines more closely the incentives that have been put in place in the WB zones.

Competitive advantages

In addition to their improvements in investment policy and promotion, the Western Balkan economies have other important advantages that are driving investment both inside and outside the zones. The region's geographical position is, naturally, a key advantage, especially its proximity to the EU and its location on the east-west divide of the Pan-European corridors, which also makes it well positioned to cater to markets in the Middle East. With the introduction of new measures that will facilitate customs procedures for transport across multiple borders, such as the New Computerised Transit System (NCTS) which allows companies to declare their goods just once in the country of origin before transiting them through multiple jurisdictions under a single bank guarantee, exporting to EU countries that do not border the region will become even easier.

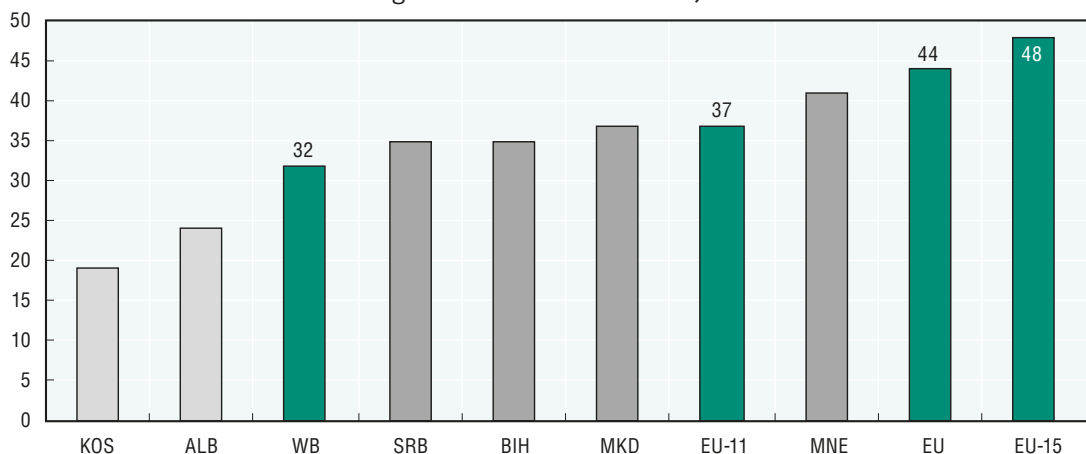
The region has free trade agreements (FTAs) with large and important markets. Three of the six Western Balkan economies are members of the World Trade Organization (WTO) and most are also signatories to many regional and bilateral trade agreements, which have supported their trade integration. Trade linkages with the EU have strengthened considerably since the signing of Stabilisation and Association Agreements (SAAs) and the free trade agreement with the European Free Trade Association (EFTA). As a result,

goods originating from the WB economies can enter the EU customs-free and without any quantitative restrictions. Most of the WB countries are also members of the regional Central European Free Trade Agreement (CEFTA) while some regional economies are also signatories to bilateral free trade agreements with large non-EU markets such as Russia, Kazakhstan and Turkey.

Labour costs have also become a relative advantage, especially compared to competitors in the textile and automotive industries. As a result of the increased political instability in North Africa and the Middle East as well as the war in Ukraine, which have removed important competitors from the investment scene, the Western Balkan economies have become an important new low-cost investment destination especially for the European automotive industry. With a 40-60% lower average gross wage than the CEE economies and about one-fifth of the average wages of more advanced EU economies, the region is particularly attractive for labour-intensive industries. Of the EU economies, only Bulgaria and, to a lesser extent, Romania can still directly compete with the WB economies with respect to low cost labour. However, both the Former Yugoslav Republic of Macedonia and Serbia have also adopted substantial labour-related incentives for foreign (zone) investors in the form of employment subsidies and exemptions from labour taxes and contributions, which further enhance the attractiveness of their labour markets especially compared to EU regional peers. As a result, in the Former Yugoslav Republic of Macedonia, for example, a company in the south-western and eastern parts of the country can pay factory workers a gross wage of less than EUR 300 per month, which is competitive even compared to less developed economies in East Asia (see Chapter 4 for more detail).

Labour cost to output ratios have also improved compared to the 1990s and early 2000s. Now WB economies record lower unit labour costs (ULCs) compared to both Central and East European and EU economies (Figure 2.4). This also explains why many investors cite skill levels as adequate, even though the WB economies still lag considerably behind CEE and advanced EU economies on most assessments of knowledge and skills. For example, in the latest Programme for International Student Assessment (PISA), all WB economies had notably lower mean scores across all three assessments (mathematics, reading and science) compared to the OECD average as well as the CEE and EU averages (Table 2.3). Nevertheless, during the interviews conducted for the purposes of this study, investors pointed out that the educational system provides workers with enough theoretical knowledge and adequate overall skills that, with additional training in the workplace, they can be easily integrated into their workforce.

Figure 2.4 Unit labour costs, 2014



Source: Sanfey et al. (2016), "How the Western Balkans can catch up"; EBRD calculations based on national statistics; Eurostat (2016b), "Labour costs annual data".⁸

Table 2.3 Average PISA scores, 2015

	Mathematics	Reading	Science
OECD Average	490	493	493
Estonia	520	519	534
Slovenia	510	505	513
Poland	504	506	501
Latvia	482	488	490
Hungary	477	470	477
Lithuania	478	472	475
Slovak Republic	475	453	461
Serbia*	449	446	445
Bulgaria	441	432	446
Romania	444	434	435
Albania	413	405	427
Montenegro	418	427	411
FYR Macedonia	371	352	384
Kosovo	362	347	378

Note: Data for Serbia is for 2012.

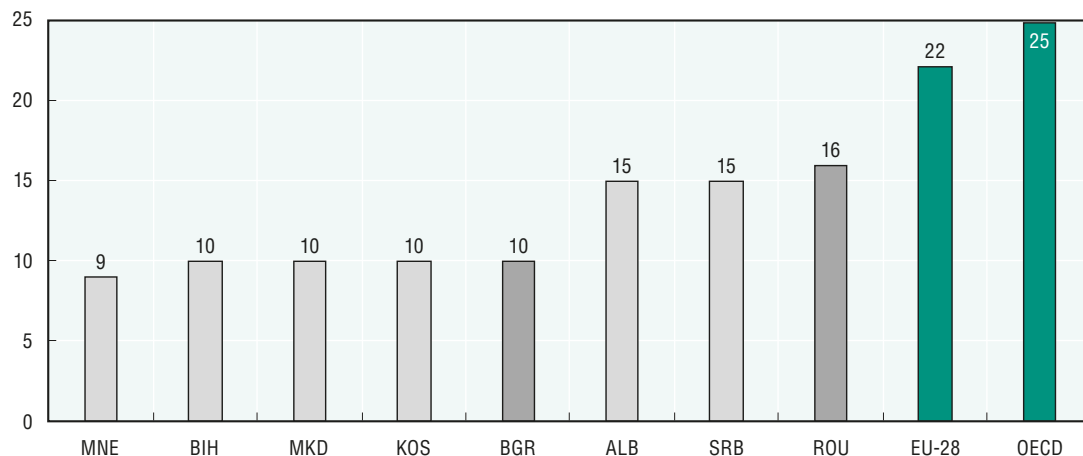
Source: OECD, (2015). PISA 2015 Database, <http://www.OECD.org/pisa/pisa-2015-results-in-focus.pdf>.

In addition to the fiscal incentives offered in the zones, the region already has one of Europe's lowest corporate income tax rates (on average 50% lower than in the EU28), ranging from 9% in Montenegro to 15% in Albania and Serbia (Figure 2.5).

The region also stands out for its low prices for energy inputs, an important factor for foreign investors in energy-intensive industries such as the automotive sector, both inside and outside the economic zones. Most regional economies record notably lower non-residential electricity prices than the EU28 countries. Serbia has the greatest advantage here, with electricity prices 44% lower than the EU28 average. Bosnia and Herzegovina comes a close second, with electricity costs of two-thirds the average EU price. Regional competitors Bulgaria and Romania, however, have relatively similar electricity prices to EU countries (Figure 2.6). The region does not stand out in terms of gas prices, which are in line with the EU averages.

All of these advantages contribute to attracting FDI investment in the region. However, as Chapters 3 and 4 will elaborate, the fiscal and non-fiscal incentives that special economic zones offer also play an important role in attracting export-oriented manufacturing FDI to the Western Balkan region.

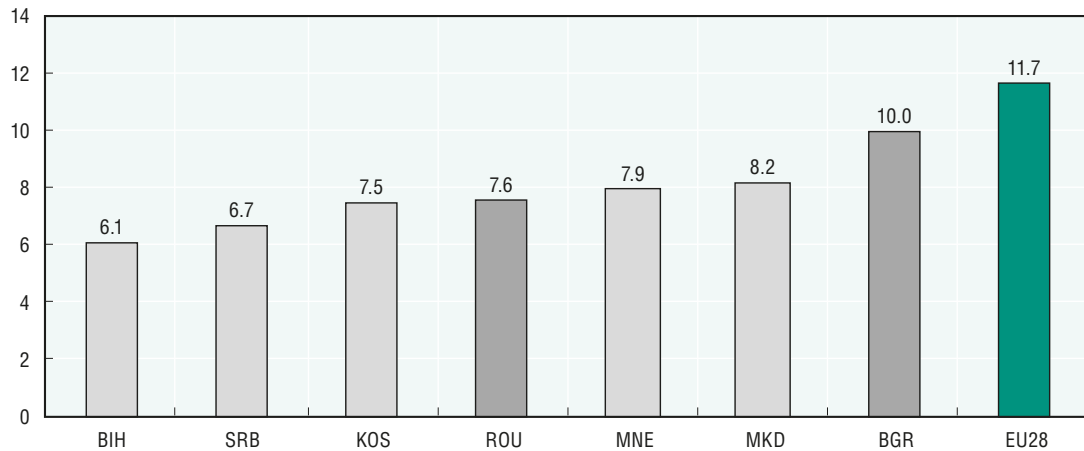
Figure 2.5 Nominal corporate tax, percentage of net profits, 2016



Source: KPMG (2016), "Corporate tax rates table", <https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html>; World Bank (2016), World Bank Doing Business (database), <http://data.worldbank.org/data-catalog/doing-business-database> (for Kosovo).

Figure 2.6 Electricity prices for industrial consumers, excluding VAT and other recoverable taxes and levies

(Eurocent per Kilowatt-hour, first semester 2016)



Source: Eurostat (2016a), "Electricity prices by type of user".

Remaining challenges

Despite the considerable progress, many challenges remain which represent important deterrents to investment in the region. Unclear property rights are a notable problem in some economies, particularly Albania. Regulatory uncertainty stemming from frequent and non-transparent changes of legislation and ambiguous fees and charges imposed at the municipal level also plague many of the economies. Infrastructure quality has improved but many challenges still persist, including unreliable electricity supplies in Albania and Kosovo and high transport costs in most economies. Western Balkan economies have entered into numerous FTAs with key regional trading partners, but non-tariff barriers to trade, such as quality standards and long, cumbersome customs procedures remain high. Coupled with the small size of the economies and the still persistent perceived risk of political instability (due to past conflicts, and more recently to frequent changes of power) in some economies, these challenges reduce the region's attractiveness to investors (Table 2.4). As Chapter 3 will show in more detail, the economic zones shelter companies from quite a few of these problems and this is one of the main drivers of investment into the zones across the region.

Table 2.4 Competitive state of Western Balkan economies

Main advantages	Main disadvantages
Geographic position (proximity to EU market, east-west divide of Pan-European corridor)	Small and fragmented market
Low cost skilled labour	Unpredictable regulatory environment/ Risk of political instability
Low corporate income tax rates	Weak contract enforcement and dispute settlement in many economies
Low prices of energy inputs (electricity)	Unclear property rights (especially Albania)
Free trade agreements	Low quality infrastructure (unreliable electricity supply in Albania and Kosovo, high transport costs)

Chapter 3

Current Western Balkan special economic zone network

This chapter provides an overview of the key features of the special economic zones in the Western Balkan region. It starts by classifying the zones based on the typology introduced in Chapter 1 and describes how the zones are owned, managed and regulated. Finally it provides an overview of the key locational features of the zones and the approaches each economy takes in determining where to locate its zones.

3.1 Classification of the special economic zones

The Western Balkan region hosts 40 established SEZs covering almost 3500 ha of land. Twenty-three of these zones, most of which are located in the Former Yugoslav Republic of Macedonia and Serbia, are fully operational and have attracted a number of significant new investors over the past eight years (Table 3.1; Annex A). Most of the remaining zones (in Albania, Kosovo and the Former Yugoslav Republic of Macedonia) have been recently established and have yet to attract any investors. The four zones in Bosnia and Herzegovina have been active for many years now, but were established around existing companies and their suppliers, so have not attracted considerable additional new investment.

The economic zones created in the Western Balkans in the early 1990s were predominantly free trade zones. They aimed to stimulate investment and trade by offering customs duty exemptions for imports and exports to and from the zones. They did not put much emphasis on attracting manufacturing investment, allowing any kind of commercial activity (including international trading companies and financial institutions) to locate in the zones. While they also sought to boost exports, either they imposed no exporting requirements at all (for example in Bosnia and Herzegovina) or they were not very high (for example in Serbia and Montenegro, only 50% or more of the goods and services produced in the zone had to be export oriented).

The WB zone systems have evolved since the 1990s as all the regional economies introduced new zone legislation in the mid- to late-2000s. As the relevant laws specify, the zones have broad overarching objectives of boosting investment and job creation, particularly in higher value-added sectors. Eligibility criteria and incentives have been designed to favour more export-oriented manufacturing activities. In most of the WB economies, therefore, the incentives largely consist of customs duty and other exemptions on the import of manufacturing inputs and the output of final products. In Bosnia and Herzegovina and the Former Yugoslav Republic of Macedonia the law on zones goes even further by specifying export-related requirements for investors operating in the zones (at least 50% of turnover in Bosnia and Herzegovina and 51-70% in the Former Yugoslav Republic of Macedonia). These factors are reflected in the types of investment that the zones have attracted thus far: largely export-oriented manufacturing activities originated mainly through greenfield foreign direct investment (FDI). As a result, with the notable exception of the free trade zone in the port of Bar, Montenegro, all of the remaining WB zones can be classified as export processing zones (see definitions in Chapter 1).

Table 3.1 Active zones in the Western Balkan region⁹

Economy	Zone name	Size (ha)	Number of investors	Cumulative investment in EUR millions
Bosnia and Herzegovina	Vogošća	11	30	n/a
	Visoko	17	23	n/a
	Holc (Lukavac)	7.5	1	n/a
	Hercegovina (Mostar)	44	41	n/a
Former Yugoslav Republic of Macedonia	Skopje 1	140	12	208
	Skopje 2	97	1	25
	Stip	206	3	12
	Tetovo	95	1	n/a
	Prilep	67	2	20
	Struga	30	2	15
	Strumica	25	1	n/a
	Kichevo	30	1	15
Montenegro	Bar (Free Port)	130	36	5
Serbia	Pirot	116	16	266
	Zrenjanin	98	5	12
	Subotica	44	5	77
	Novi Sad	75	6	4
	FAS Kragujevac	176	7	1278
	Sabac	244	1	4
	Uzice	55	6	39
	Krusevac	65	1	1
	Smederevo	143	6	6
	Svilajnac	33	1	1

Note: data on cumulative investments in Serbia cover the period 2006-15, in Montenegro 2011-15.

Source: Data compiled by the OECD and gathered from national zone administrators.

3.2. Zone ownership and management

Ownership and management modalities vary considerably across the WB region (Table 3.2).

The Former Yugoslav Republic of Macedonia has a system of technological and industrial development zones (TIDZs) which are almost fully publicly owned, with the only exception being the free zone in Tetovo which is operated as a PPP between the TIDZ authority and a Norwegian company. The management structure is fairly centralised with considerable decision-making powers concentrated in the central zone administrator, the Directorate of the TIDZs. The Directorate is responsible for zone development and management, all co-ordination with other government bodies, and facilitating the provision of all government services. The zone administration also has considerable responsibility for investment promotion in the zones, negotiating incentive contracts with prospective investors on behalf of the Government, and providing aftercare services for zone investors.

In Serbia the zone management system is fairly decentralised and governed by public-private partnerships between local municipalities and private operators. Local municipalities are responsible for co-ordinating and facilitating the provision of public services and provide aftercare services to zone investors, jointly with private operators. This means the zones in Serbia are much more heterogeneous in how they are governed and the services they offer (see Chapter 4 for more detail). The Free Zones Administration (FZA), housed within the Ministry of Finance, has overall responsibility for supervision and co-ordination. It generally serves as the first point of contact for investors along with the Serbian Development Agency, and is also responsible for negotiating incentive packages with each investor. It drafts yearly reports on the functioning and performance of the zones and works together with the Ministry of Finance to propose changes in zone operations or the incentives they offer.

In Bosnia and Herzegovina, and Montenegro, zones are fully privately owned and operated under the supervision and regulatory oversight of the government (the Ministry of Foreign Trade and Economic Relations, and the Council of Ministers in Bosnia and Herzegovina; the Ministry for International Economic Relations and European Integrations in Montenegro). These zone systems are also unique in that they require the zone manager to also be a zone user. For instance, in Bosnia and Herzegovina the zones were established around existing manufacturers who applied for and met the criteria for zone status as prescribed by the law on zones (meeting the economic justification and the spatial and infrastructural utility requirements and with well-regulated property rights inside the proposed zone territory).

The newly established zones in Albania and Kosovo envision either PPP or fully private zone management, depending on whether the zone is developed on public or private land. As in Bosnia and Herzegovina, if a zone is to be created on private land, the zone founder has to make the economic case for establishing a zone on that territory and demonstrate that all legal, environmental and other conditions have been met. In cases where the zone is publicly owned but leased or sold to a zone developer, a tendering process will select the best developer. Again, as in Bosnia and Herzegovina, candidate developers have to demonstrate that they can provide the spatial, infrastructural and environmental conditions necessary for economic activity on that territory. At the time of writing, tenders have been issued for the development of zones in Koplik and Spitala in Albania.

3.3 Zone regulation

As signatories to Stabilisation and Association Agreements with the EU, the Western Balkan economies have to comply with EU rules on competition and state aid (for more detail on EU state aid rules, please see Chapter 4), and this also entails the regulation of special economic zones.

In the EU economies which still operate zone systems, the zone administration function is separated from the regulatory function to prevent conflicts of interest. Thus, in the EU economies the zone administration is tasked with promoting zone investment and overseeing the development and economic performance of the zones. However, the review of compliance *vis-à-vis* EU competition and state aid rules is in the remit of a separate public institution, usually the country's competition authority. This institution thus has to review and approve every investment deal that involves the granting of state aid of any kind.

In BIH, the zones are overseen by the Ministry of Foreign Trade and Economic Relations, which approves the zones' establishment and to which they submit an annual report of economic activity. The State Aid Council, established in 2012, is charged with overseeing the application of the state aid law on a case by case basis, both outside and inside the special economic zones. However the Council is underfunded and understaffed and state aid measures are often introduced before the Council formally approves them, which puts in question the significance of its decisions (European Commission 2016a).

In the Former Yugoslav Republic of Macedonia, as in the EU economies, there is a separation between the function of regulator and zone administrator. Regulatory compliance, including compliance with EU state aid rules, is the responsibility of the Commission for the Protection of Competition (CPC). The Commission provides mandatory assessment of state aid compliance ahead of the signing of any zone investment deal. Its assessment is provided to the Government and if any non-compliance is noted, it has to be corrected before the deal can be finalised and the investment realised. According to the Law on State Aid, every state aid provider is also obliged to inform the Commission of any plans to grant new or alter the existing state aid. However, relying on only three staff members and outdated equipment, the CPC's constrained administrative capacity can pose a challenge in light of the increased number of applications for the granting of state aid (European Commission 2016b).

In Serbia compliance with state aid rules is overseen by the Commission for State Aid Control (CSAC). However, even though it is a distinct entity, the Commission is housed within the same ministry as the Free Zones Administration – the Ministry of Finance – so the separation of the administrative and regulatory functions of the zones is not so clear. In addition, members of the CSAC are nominated by the same ministries that grant State aid, and not all State aid goes through a revision by CSAC (European Commission 2016c). Transparency on State aid procedures is thus still limited.

Table 3.2 Zone ownership, regulation and management in the Western Balkans

Albanian Technical and Economic Development Areas	
Zone ownership	Private/PPP
Zone regulator	The Ministry of Economy regulates the zones and is responsible for ensuring that zone operations and investments are compliant with Albanian law and EU state aid rules. Albania's institutional infrastructure thus differs from most EU economies, where zone administration and regulatory responsibilities are usually allocated to two separate institutions
Zone development	Zones in Albania can be developed either on public or private land, and zone developers are selected by the Ministry of Economy by tender.
Zone administration/management	Economic zones are to be administered by the establisher who is obliged to ensure it has the financial means to establish and administer the zone.
Bosnia and Herzegovina's Free Zones	
Zone ownership	Private
Zone regulator	The Council of Ministers is responsible for overseeing the zones. Each zone administration is responsible for preparing annual reports on the zones' performance, which are submitted to the Ministry of Foreign Trade and Economic Relations, and then forwarded on to the Council of Ministers for review of compliance with domestic and EU regulations.
Zone development	Commission for the Establishment of a Free Zone.
Zone administration/management	Private company.
Former Yugoslav Republic of Macedonia's Technological and Industrial Development Zones	
Zone ownership	Public, except for one PPP in Tetovo.
Zone regulator	The competition authority, the Commission for the Protection of Competition, is responsible for regulatory compliance, including compliance with EU state aid rules. The commission monitors state aid compliance but also provides a mandatory assessment on the alignment with state aid rules before any zone investment contract is signed. Its assessment is provided to the government and if any non-compliance is noted, it has to be corrected before the deal can be finalised and the investment realised.
Zone development, administration and management	The Directorate of the TIDZs is responsible for zone development and management, all co-ordination with other government bodies, and facilitating the provision of all government service. The zone administration also has considerable responsibility for investment promotion in the zones, negotiation of incentive contracts with each investor, and aftercare services for all zone investors.
Kosovo's Free Economic Zones	
Zone ownership	Private/PPP
Zone regulator	The Ministry for Trade and Industry regulates free economic zones, and keeps a registry of all zones.
Zone development	Economic zones may be established on the decision of municipalities within the territory, or at the request of one or more Kosovan business organisations or associations.
Zone administration/management	Economic zones are administered by the establisher who is obliged to ensure it has the financial and other necessary means to found and administer the zone.
Montenegro's Free Zones	
Zone ownership	PPP
Zone regulator	The government of Montenegro decides on the establishment of a zone based on the proposal by the Ministry for International Economic Relations and European Integrations. Before zone operations can begin, the founder must submit a request to the Customs Administration of Montenegro to obtain clearance to start activities in the zone.
Zone development	Not stated in the law.
Zone administration/management	Zones are managed by an operator, which may be any domestic or foreign, legal or natural person determined by the by-law on its establishment. In addition to managing the zones, the operator may also be one of the users, which is defined in the contract with the founder.
Serbia's Free Zones	
Zone ownership	PPP
Zone regulator	The Zone administration is responsible for monitoring and assessing compliance with EU state aid rules.
Zone development, administration and management	The Free Zones Administration has the overall supervisory and co-ordination authority and serves generally as a first point of contact for investors, along with the Serbian Development Agency. The agency also drafts yearly reports on the functioning and performance of the zones and works together with the Ministry of Finance to propose changes in the zone operations and incentives granted to the zone users. It is also responsible for negotiating the incentive packages with each investor.

3.4 Location of the special economic zones

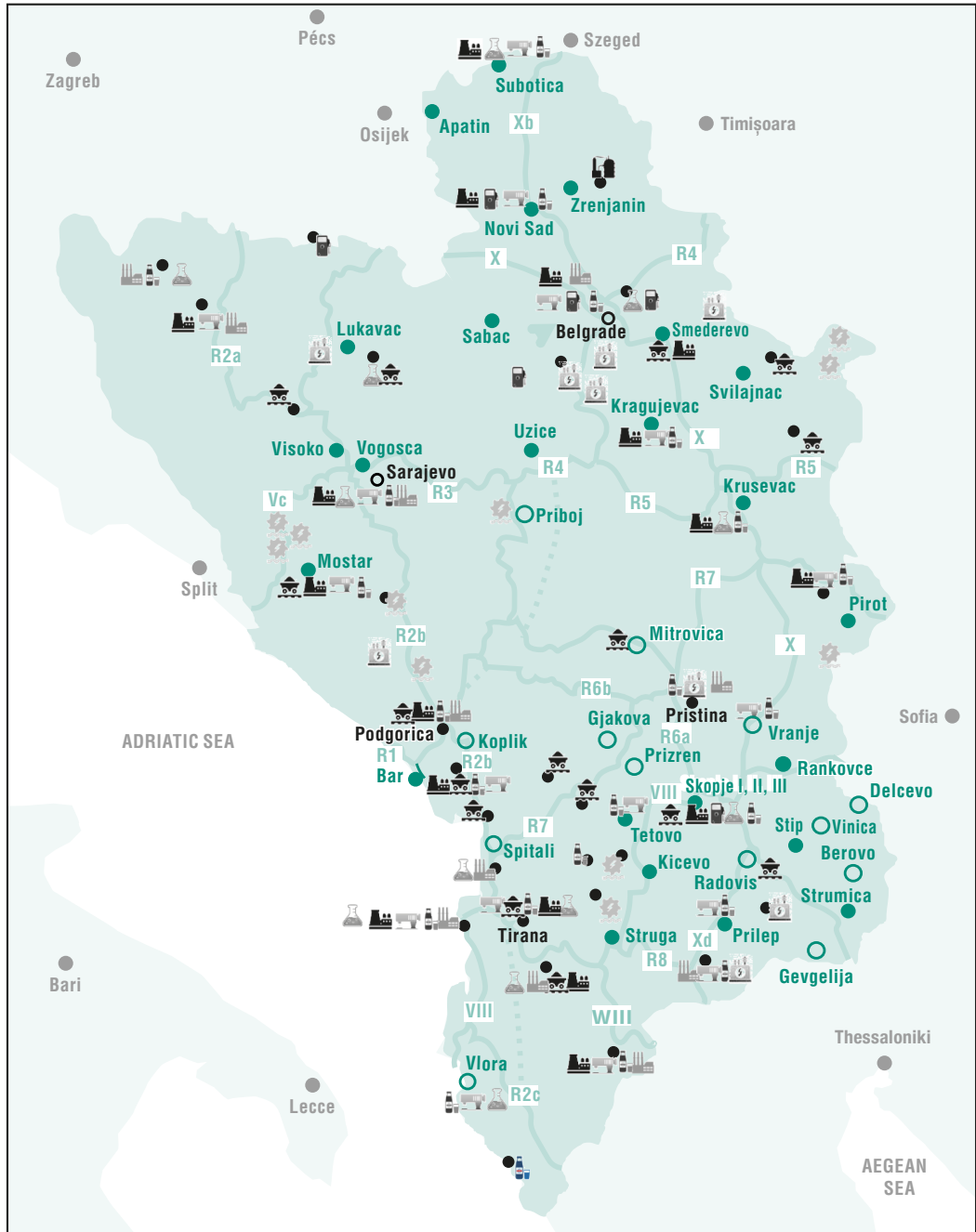
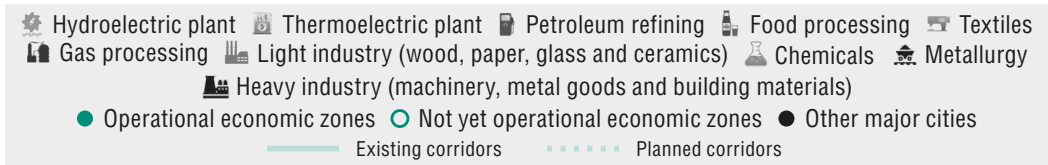
In light of their focus on attracting investment, most WB zones are located in strategic geographical positions near major cities, transport corridors, key borders or major ports (see Table 3.3 for more detail). Looking at the map in Figure 3.1, it is also apparent that the zones build considerably on the industrial heritage of the former Yugoslavia and post-World War II Albania.

In Bosnia and Herzegovina, for example, three out of four zones (Herzegovina, Visoko and Vogošća) are in the sites of large industrial conglomerates of the former Yugoslavia. Visoko was the headquarters of the biggest leather company in Yugoslavia, KTK, and the Herzegovina zone in Mostar used to be the headquarters of an aircraft and ammunition manufacturing company, SOKO. Similarly, Volkswagen's joint-venture factory in socialist Yugoslavia was located in the town of Vogošća, which made the locality one of the country's main centres of the automotive industry.

The zone in Kragujevac, in southern Serbia, was developed inside the industrial area where subsidiaries of large automotive manufacturers such were already operating in the former Yugoslavia – for example, Fiat in co-operation with its licence-carrier in Yugoslavia, the car, tractors and military equipment manufacturer Zastava. Similarly, the Pirot zone is located in the factory area of Tigar, a Yugoslav enterprise specialising in rubber products and tyres, which was bought by Michelin in 2003. In Priboj, a zone was placed around the former factory installations of Fabrika Automobila Priboj – a major Yugoslav truck and bus manufacturer. The zones in Serbia's northern region of Vojvodina, one of Yugoslavia's most developed provinces, are also located around former agro-industrial and manufacturing powerhouses, such as Subotica (one of the country's centres of agro-industrial production), Zrenjanin (with a noticeable presence of textile, pharmaceutical and agro-industrial production facilities in the former Yugoslavia), and Novi Sad.

The sectoral composition of investment in the zones bears a close resemblance to the sectoral focus of the industrial clusters that previously existed there. In the Former Yugoslav Republic of Macedonia, for example, during Yugoslav times, Skopje housed 11 Oktomvri, one of the largest bus manufacturers in the former Yugoslavia, so it is no coincidence that in 2013, Belgian bus manufacturer Van Hool chose the zone Skopje 2 as location for its newest bus assembly plant. Shtip was the centre of the textile and apparel industries during Yugoslav times, and today its zone hosts Johnson Controls, which manufactures car seat covers, and the German company Technical Textiles. Ohrid was the headquarters of electrical and cable company EMO, which is why ODW Elektrik, a leading German cable manufacturer for the automotive industry located in the nearby zone in Struga.

Figure 3.1 Zone network in the Western Balkan Region



Source: Derived from University of Texas at Austin (2016), "Map collection", www.lib.utexas.edu/maps/.

Recent trends point to increased interest in using the zones as an instrument to stimulate investment in the relatively underdeveloped parts of the economy. The Former Yugoslav Republic of Macedonia, for example, recently expanded its zone network eastward. These areas have the advantage of cheaper labour costs than other parts of the country, but are located away from main corridors, in predominantly agricultural areas with a comparatively limited industrial history and a limited network of relevant educational institutions. However, as part of the broader development agenda that seeks to alleviate poverty and boost employment in these regions, the government has invested considerably in upgrading the regional road infrastructure so as to improve connectivity to the main corridors and it has also established many new universities and technical schools in hope that they can provide a qualified workforce for the needs of potential zone investors. Adient Seating (formerly Johnson Controls) is the only investor in these newly established zones, having opened a textile factory for the manufacture of car seat covers in the zone in Strumica. It remains to be seen how quickly these zones can develop and what type of investment they will attract.

The determination of zone locations varies from economy to economy. Some adopt a top-down approach to the establishment of zone networks, with the government deciding on the location and the size of the territory that will gain zone status. Others take a bottom-up approach whereby local municipalities or even companies can request the granting of zone status. Last but not least, some economies use a mixture of the two approaches.

In most WB economies, central governments have established the initial network of zones. In some cases these have been expanded at the initiative of local municipalities or private investors as prescribed in the zone legislation. In most cases, where the request comes from investors, the receipt of zone status is conditional upon stricter investment and employment requirements compared to other zone investors.

In Serbia some zones were developed around a specific company location, such as the zone Fiat Chrysler Serbia established in Kragujevac for itself and its suppliers on the site of the ex-Yugoslav car manufacturer Zastava. Other zones were extended to meet the needs of specific companies, such as Dräxlmaier in Zrenjanin, which started its operations on the current location in 2008 before acquiring zone status in 2011; Lear is expected to start operations in Novi Sad in an area that has yet to acquire a zone status. In these cases, the law allows for the creation or expansion of zones but there are investment- and employment-related pre-requisites that have to be met: zone investment must exceed EUR 3 million (and at least EUR 1 million in the first year), the share of foreign investment must exceed 50% and at least 100 new jobs have to be added in the first 2 years (Official Gazette of the Republic of Serbia, 2006).

Table 3.3 Zone location features by economy

Economy	Proximity to major transport corridors	Proximity to key borders, ports, etc.	Proximity to (former) industrial hubs	Underdeveloped regions
Albania	<ul style="list-style-type: none"> Spitalla in the intersection of the VIII and Blue road corridors. Koplik is adjacent to the Shkodra-Hani Hotit highway connecting Albania and Montenegro. The Vlora zone is located close to the Blue Corridor. 	<ul style="list-style-type: none"> Spitalla located near Tirana international airport, and the harbour of Durres. Koplik, on the border with Montenegro, is located close to three sea ports (Bar, Durres and Shëngjin). The Vlora zone is near the town's port, as well as Valona's harbour. 	<ul style="list-style-type: none"> The Spitalla zone is located in the region where most economic activity is clustered. The zone Koplik was located in the relatively highly industrialised county of Shkodra, which specialises in textiles and agro-food processing as well as wood processing and cable production. 	No
Bosnia and Herzegovina	<ul style="list-style-type: none"> All zones close to road and rail Pan-European corridor Vc (E-73). 	<ul style="list-style-type: none"> All zones close to international airports (Tuzla, Mostar and Sarajevo). The Mostar and Lukavac zones close to the border with Croatia (border gate of Bijača for the former, ports of entry of Brčko, Orašje and Bosanski Šamac for the latter). The Mostar zone 60 km far from the Ploče sea port. 	<ul style="list-style-type: none"> All zones established in former heavy industry hubs (SOKO in Mostar, Volkswagen in Vogošća and KTK in Visoko). 	No
Former Yugoslav Republic of Macedonia	<ul style="list-style-type: none"> Skopje 1, 2 and 3 and Gevgelija are near Pan-European Corridor X (E-75) and Tetovo, Kicevo and Struga are near Corridor VIII (E-65). 	<ul style="list-style-type: none"> Skopje 1, 2 and 3, and Gevgelija are near border crossings with Serbia and Greece, respectively. Skopje 1, 2 and 3 and Tetevo zones are close to Skopje's international airport. 	<ul style="list-style-type: none"> Most locations still correspond to industrial hubs in the former Yugoslavia. The sectoral distribution of zone investments also mimics quite closely the sectoral specialisations of these ex-Yugoslav hubs 	Formally all zones receive regional state aid, but there are areas in eastern and south-western parts of the country which are poorer and more disadvantaged.
Kosovo	<ul style="list-style-type: none"> Mitrovica and Prizren are close to European routes (E-65 and E-80, and E-851 respectively). However, the zone's connectivity to important Pan-European corridors remains limited. 	<ul style="list-style-type: none"> Djakova and Prizren zones are located near borders (with Albania, and Albania and the Former Yugoslav Republic of Macedonia respectively), while Mitrovica is close to Serbia. 	<ul style="list-style-type: none"> The Prizren zone is close to the city's former industrial hub (metallurgy and textiles). 	Yes, zones are seen as a tool of regional development. This is particularly true for the Djakova zone.
Montenegro	<ul style="list-style-type: none"> The Free Port of Bar is situated near European route E-80. 	<ul style="list-style-type: none"> In relative proximity to international airports in Podgorica and Tivat. 	No	No
Serbia	<ul style="list-style-type: none"> The majority of zones (9 out of 11) are located in proximity to Corridor X and Corridor VII. 	<ul style="list-style-type: none"> Five zones are located near borders and several are located in relative proximity to two of the international airports (in Belgrade and Nis). 	<ul style="list-style-type: none"> Yes, all zones placed in locations with a significant past as industrial hubs. 	No

Chapter 4

Zone incentives in the Western Balkan economies

This chapter focuses on the incentive features of each economy's zone network. It describes the role that incentives play in attracting investment into the zones and details the fiscal and non-fiscal incentives that are offered in each economy. The chapter takes a closer look at the zones in Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia and Serbia as these economies have the largest network of operational zones that rely on a variety of incentives to attract investment.

4.1. The role of incentives in the Western Balkan special economic zones

The zone incentive systems of the Western Balkan economies show considerable variety (see Table 4.2). The Former Yugoslav Republic of Macedonia currently offers a wide range of fiscal and non-fiscal incentives; Bosnia and Herzegovina, Serbia, and Montenegro offer mainly cash-flow based customs and value-added tax (VAT) exemptions; while Albania plans to introduce a wider array of incentives once its zones will be fully operational, starting with VAT and custom exemptions on all goods, increased capital expenditure deductions, tax rebates and exemptions, and more.

The incentives are important drivers of investment into the zones not only because they reduce the investors' operational costs, for example through lower tax obligations, but also because they shield investors from considerable obstacles that otherwise persist in the region.

As noted in Chapter 2, reliable access to electricity is a major challenge for large manufacturers especially in Albania and Kosovo. The zones alleviate this problem by providing dedicated power lines and/or sufficient generator capacity for zone users to limit the impact of power outages that affect other parts of the economy.

By providing customs terminals on the territories of the zones as well as exempting investors from paying customs duties, the zones relieve investors of the considerable burden of long and cumbersome customs procedures at border crossings.

Zones shelter investors from the numerous and highly unpredictable fiscal and para-fiscal charges imposed by local administrations. In most cases, the zone administration also acts as an intermediary between investors and the local government facilitating the procurement of necessary licences, access to municipal infrastructure and so on.

Most zone laws also stipulate that property rights have to be well regulated within the territories of the zones, offering a major advantage for zone investors in economies where property rights are not well regulated. Unfortunately one exception here is Albania, which also happens to have the largest issue with property rights regulation. The Albanian zone law explicitly excludes references to property rights noting that such issues have to be resolved between the land owners and the zone developers.

Since most regional economies have low tax levels, the importance of fiscal incentives is less clear. In the context of already relatively advantageous labour costs, neither are the importance and value-added to investors of labour-related incentives such as labour subsidies in Serbia and exemption from labour taxes and contributions in the Former Yugoslav Republic of Macedonia. However, given the economies' otherwise relatively similar endowments, such incentives are becoming important distinguishing features and one of the key vehicles through which regional competition for investment is taking place.

The Former Yugoslav Republic of Macedonia currently offers the widest range of incentives, particularly fiscal ones (Table 4.2), and its relative success in attracting considerable new manufacturing investment to its zones is putting competitive pressure on other economies in the region. Serbia has considered the introduction of additional fiscal incentives, but nothing concrete has been put forward yet. However, as Albania and Kosovo establish their own zone networks and begin to offer fiscal and non-fiscal incentives for prospective investors (Albania has formally announced the introduction of such measures), the regional competition for FDI is bound to intensify.

According to the economic literature, regional competition can have considerable negative impact on the economies if it leads to 1) deadweight losses, i.e. providing incentives to investors who would have invested anyway; or 2) beggar-thy-neighbour policies, whereby countries try to outbid each other in terms of incentives in order to attract investors. There is emerging evidence of both of these detrimental effects in the region, and it is therefore important to take a critical look at these developments and

particularly the types of incentives economies are relying on in this competitive race for investment. Box 4.1 provides some insights from an OECD study on this subject and Chapter 6 puts forward some critical questions to be examined in this context.

4.2. Zone incentives in Bosnia and Herzegovina

Bosnia and Herzegovina offers a limited range of fiscal advantages specifically targeting special economic zones. The main fiscal advantages for zone investors include VAT exemptions for production equipment introduced into the zones and the exemption of raw and semi-finished material imported in the zones from customs duties. However, even though the Law on VAT from 2005 explicitly excludes special economic zones from paying VAT on production equipment, the implementing acts were never introduced. As a result, companies have had to pay VAT on all imported materials but most have contested these payments and sought compensation through the court system. The courts have ruled in favour of the companies, but the recovery of the VAT was achieved after lengthy procedures and additional legal costs. The current institutional set-up has thus created considerable uncertainty about the application of incentives in the zones and has acted as a deterrent for investment in the zones in recent years.

Investors can benefit from additional incentives for hiring new workers or for reinvesting profits, but these are not limited to the SEZs. Therefore, the only real benefits of SEZs in Bosnia and Herzegovina have been non-fiscal and largely linked to the presence of customs terminals within the zones. These terminals operate with longer business hours compared to standard customs terminals enabling faster and smoother customs clearance for zone investors.

4.3. Zone incentives in the Former Yugoslav Republic of Macedonia

The Former Yugoslav Republic of Macedonia offers zone investors a variety of tax and non-tax incentives. These include corporate tax exemptions, exemption from personal income tax for zone employees and exemption from customs duties. All tax incentives are offered uniformly across all zone investors. Furthermore, tax incentives are zone-specific and thus available only to investors who have zone status.

The zones also offer non-tax incentives, including the provision of on- and off-site infrastructure and services. Most non-tax incentives are granted to all investors, but some are only offered on a selective basis depending on factors such as the size of the investment and the number of people employed. Most investors have noted the benefits of being able to design and build facilities according to their exact specifications inside the zones. The provision of immediate good quality power and utility connections is another important incentive for location inside the zones.

In addition, the zones offer one-stop shop services (issuing building and operational permits, customs outpost in the zone, zone infrastructure maintenance and upgrades), aftercare, business opportunities analysis (identification of project specific location factors, cost analysis, identification of supplier base and detailed due diligence), and opportunities to connect with domestic enterprises through a supplier database.

Since most of these incentives are zone-specific, they offer considerable advantages to investors inside the zones. It is therefore not surprising, that the zones have played an important role in attracting considerable manufacturing investment to the economy since their establishment in 2007. Today they account for a large share of all manufacturing FDI inflows, domestic manufacturing activity and exports (over 30%). However, key questions remain regarding the cost-effectiveness of these zone policies, how sustainable zone investments will be once the incentives expire, and how spillovers from these investments can be strengthened through backward linkages, education and skills (see Chapters 5 and 6 for more detail).

4.4. Zone incentives in Serbia

In Serbia, there are fewer advantages of operating in the zones and so it is not as obvious if the zones themselves are really making a difference in attracting FDI into the economy. Serbia has a fairly broad range of tax incentives independent of presence in the zones. The state offers employment subsidies and some tax incentives that apply to all investors who meet the eligible criteria related to investment size and employment (please see the Serbia page in Annex B). Furthermore, the customs and VAT exemptions that zone investors enjoy can also be used by non-zone investors so long as their intermediate goods come from countries with which Serbia has preferential trade agreements (EU, Russia and Turkey), which accounts for the majority of investors. The only tax benefits that apply exclusively to zone investors relate to the VAT exemptions on raw material, imported equipment and the payment of VAT on energy inputs.

When first formed in 2006, Serbia's zones distinguished themselves by their customs procedures, which were much simpler and easier due to the existence of customs terminals within the zones. However, this feature is not zone specific – large companies are also able to apply for the establishment of customs terminals. It could also become less relevant over time, as Serbia signs free trade agreements with different partners and simplifies and streamlines its custom procedures at the national level (in-house, e-customs, New Computerised Transit System) for all companies.

Serbia also offers a smaller range of non-tax incentives than the Former Yugoslav Republic of Macedonia. Serbian zones provide good infrastructure, in-house customs and some basic equipment for their users. A number of zone investors have noted how proactive the zone administration can be in facilitating issues with the local administration or providing aftercare services. The zone in Pirot stands out for the wide range of services it offers its investors, from shipping and handling of goods to in-house customs and transport via the port of Burgas in Bulgaria.

In this context, it is not surprising that Serbia continues to attract a considerable amount of manufacturing investment outside the zones. One of the main challenges that Serbian zone authorities face is thus to justify having specific zones and zone policies at all. Other important questions relate to the cost-effectiveness of the labour subsidies and other incentives that are offered to all investors irrespective of zone status and the scope for enhancing the benefits and spillovers from all of the manufacturing FDI in the zones (see Chapter 6 for more detail).

Box 4.1 OECD Checklist for FDI incentive policies

In 2003, the OECD published a report on the key principles and policy options for attracting FDI, offering a checklist for policy makers to assess the usefulness and relevance of FDI incentive policies.

The main conclusion of the report was that the most effective policies for attracting FDI are those which improve a country's general economic and business environment, rather than targeted tax incentives, financial subsidies and regulatory exemptions directed at foreign enterprises and some investors over others. Thus the most effective policies include:

- safeguarding public sector transparency;
- ensuring the principle of non-discrimination between foreign and domestic enterprises;
- providing rights of free transfers related to an investment and preventing arbitrary expropriation;
- promoting a healthy and competitive framework for the domestic business sector;
- removing obstacles to international trade;
- re-addressing aspects of the tax system that constitute barriers to FDI.

Box 4.1 OECD Checklist for FDI incentive policies (cont.)

The OECD acknowledges that incentives can contribute to an efficient allocation of FDI, but they can also distort competition and come at an excessive cost for the international community and, in the long run, for the host country as well. Therefore, the OECD report lists the FDI incentives available to policy makers, with the positive and wasteful outcomes of each, providing guidance on the challenges and risks that host countries should take into consideration before providing these types of incentives. There are five main ways incentives aimed at enhancing FDI can be wasteful:

- **ineffectiveness**, when the benefits to the host economy of the FDI do not exceed the cost of attracting it;
- **inefficiency**, when benefits exceed the costs, but authorities fail to maximise benefits and/or minimise costs;
- **opportunity costs**, when scarce public resources are allocated to FDI incentives instead of more profitable alternatives;
- **deadweight loss**, when:
 - the investment would have occurred regardless of the incentives;
 - the intended recipients have not been properly specified, reaching too many applicants;
 - the authorities have to offer offsetting subsidies to other enterprises to balance state-aid provision across sectors;
 - the incentives effectively raise the bar so future investors will not now invest without similar or better subsidies;
- **triggering competition**, when some jurisdictions introduce unbalanced incentives, leading others to react by offering similar or even better conditions in order to attract investors.

The OECD offers a set of operational criteria, against which countries can check the relevance, quality and coherence of their FDI incentive policy framework:

- a. **The desirability and appropriateness of offering FDI incentives.** Policy makers need a proper understanding of the relationship between the broader economic environment and the incentive framework: incentives should not be substitutes for an attractive environment, characterised by improved business climate and reduced operational risks.
- b. **Frameworks for policy design and implementation.** National authorities need to carefully decide what level of government has the power to provide FDI incentives, to avoid wasteful competition among different regions.
- c. **The appropriateness of the choice of strategy and policy tools.** By departing from the principle of non-discrimination, authorities need to consider the cost of maintaining a level playing field with regard to incentive measures.
- d. **The design and management of individual programmes.** Policy makers need to carefully consider how to minimise deadweight losses from the start. There is a high risk of incentives being too heavily front loaded, risking rent-seeking investors staying only until incentives expire. The value of FDI incentives should be also carefully considered.
- e. **Transparency of procedures (evaluation, monitoring and follow up).** Sound and comprehensive cost-benefit analyses should be performed independently and on a regular basis. These need to carefully address a number of challenges, including: having the budget to conducting the analysis, choosing when it will be most relevant, choosing the right approach and methodology, what quantitative and qualitative data are available, and understanding the relationship between investors and authorities in providing objective and complete analyses.
- f. **Assessing the extra-jurisdictional consequences of FDI incentive strategies.** Authorities should avoid the risk of triggering retaliation, taking into consideration potential reactions from neighbouring and similar jurisdictions, and also international obligations such as trade and investment agreements.

Source: OECD (2003c), Checklist for Foreign Direct Investment Incentive Policies, www.OECD.org/investment/investment-policy/2506900.pdf.

4.5. Zone incentives in the EU accession context

The European Union regulates the incentives member states offer to companies under the competition and state aid provisions of the Treaty on the Functioning of the European Union (TFEU). The relevant articles of the TFEU – 101 (ex 81 TEC), 102 (ex 82 TEC), 107 (ex 87 TEC) and 108 (ex 88 TEC) – forbid any distortive or restrictive practices that can affect internal market competition, but allow for a limited number of exceptions on state aid.

The EU recognises three broad types of state aid: horizontal, regional and sectoral aid. Horizontal aid is aimed at resolving or alleviating market failures, usually encompassing some sort of externality (i.e. the social costs a determinate business entails, regardless of business cost or revenue). Such externalities can thus be linked to any type of business, regardless of the firm's location or sector. Funding for this type of state aid is mainly channelled towards research and development (R&D) projects, rescue and restructuring, fostering employment, protection and improvement of the environment, and the creation (and later survival) of small and medium-sized enterprises (SMEs).

Regional aid targets territories where standards of living are noticeably lower than the EU average or regions disadvantaged relative to national averages, for instance due to abnormally high unemployment rates, or problems of other socio-economic, geographical or structural natures. The purpose of regional aid funding is to promote activities which can provide a basis for long-term regional growth; as such, the focus is on aid for initial investment, and operating aid is only granted under very exceptional circumstances.

Sectoral aid targets specific sectors undergoing a significant conversion process, such as coal, steel and shipbuilding; or distinct sectors finding it difficult to adjust to the full forces of market competition (such as banking, airlines or the automotive sector). The latter aid, however, is administered in such a form as to reduce as much as possible any harm to competitors.

The state aid awarded to enterprises in special economic zones falls largely under the category of regional aid. Under Article 107 (ex 87 TEC), paragraph 3a, regional aid is defined as “aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment”. The level of state aid awarded is conditional upon the level of the development of the region as measured by its GDP relative to the average EU28 GDP. Therefore, only regions with GDP per capita below 75% of the EU28 average are eligible for state aid. Moreover, poorer regions are eligible to receive a higher amount of state aid than more developed regions (Table 4.1).

The amount of state aid also varies depending on the size of the investor. Aid intensity is lower for large enterprises than for SMEs. Horizontal aid targeting SMEs¹⁰ is also available and compatible in some cases with regional aid. While the regional aid is regulated by the TFEU, aid for SMEs is defined by the General Block Exemption Regulation (GBER), which details categories of aid compatible with the internal market. According to the GBER, medium-sized firms are entitled to aid of 10% of the investment amount in addition to any regional aid they have already received, while small firms can receive up to 20% more than the regional aid intensity limit. For large investments, aid intensity should be progressively reduced: 100% of the full rate can be applied for investments up to EUR 50 million, 50% between EUR 50 and EUR 100 million, and 34% for anything over EUR 100 million.

Table 4.1 **Maximum aid intensities allowed in the European Union**
(% of total investment)

Regional GDP as % of EU25 GDP	Maximum aid rates for large companies	Additional aid for SMEs
>75%	15-10%	+20% for small enterprises
<75%	30%	
<60%	40%	+10% for medium-sized enterprises
<45%	50%	

Source: derived from European Commission (2008), *Vademecum: Community Law on State Aid*.

According to the GBER, regional state aid awarded to enterprises is calculated as the relevant aid intensity (i.e. depending on the region and the size of the enterprises/investment) multiplied by the eligible costs. Eligible costs could be 1) costs of investment in tangible and intangible assets; 2) the estimated wage costs arising from job creation as a result of the initial investment, calculated over a period of two years; or 3) a combination of 1) and 2) but not exceeding the amount of either one, depending on which is highest.

All Western Balkan economies have signed Stabilisation and Association Agreements (SAAs) with the European Union (the Former Yugoslav Republic of Macedonia in 2004, Albania in 2009, Montenegro in 2010, Serbia in 2013, Bosnia and Herzegovina in 2015, and Kosovo in 2016). SAAs are part of the process of integrating candidate countries into the European Union, through which they commit to harmonising their national legislation with the EU *acquis*. While none of the WB candidates has yet opened negotiations on Chapter 8 of the *acquis*, which regulates competition policy and state aid, as signatories to SAAs, they have all committed to align their state aid with the Treaty on the Functioning of the European Union within four years from the respective agreements.

The state aid awarded to enterprises in the special economic zones in the Western Balkan economies falls under the category of regional aid and is subject to quantitative restrictions similar to those in EU economies. According to the laws on state aid, and in line with EU regulations discussed above, the level of aid awarded to each enterprise is calculated based on the size of the investment as well as the number of people employed. The amount of state aid can be higher for SMEs. In the case of Serbia, aid intensity can reach up to 100% of the investment costs for SMEs (Official Gazette of the Republic of Serbia, 2013).

In practice, this means that Western Balkan economies are currently restricted on the amount of state aid they can award, but not the type of aid that enterprises can receive. Thus, they can provide a wider range of tax- and non-tax incentives to investors than their EU peers. This gives them important advantages especially over regional EU competitors who, according to the EC Guidelines on regional state aid for 2014-2020 need to provide detailed demonstrations that their chosen aid tool has the least distortive effects on competition compared to any other available instrument: a condition that more aggressive forms of subsidies, such as direct subsidies on labour cost, often fail to meet. The fact that EU economies cannot provide labour-related incentives gives the Western Balkan economies considerable opportunities to attract investments in labour intensive industries. This is particularly important with regard to Bulgaria and Romania which have relatively similar labour costs to the Western Balkan economies but also have considerable advantages associated with EU membership (for example, all other things being equal, foreign investors will most probably choose to locate in an EU-member country rather than outside the European Union).

Table 4.2. Tax and non-tax incentives per economy

Tax incentives	
Albania	<ul style="list-style-type: none"> Albanian goods that enter Technical and Economic Development Areas (TEDAs) are exempted from VAT and custom duties. Capital expenses are 120% deductible for two years if developers and users invest in the TEDA within three years of its operation. Developers and users are also exempted from 50% of the profit tax rate (currently at a rate of 15%) for 5 years. Developers' projects are exempted from infrastructure taxes. Buildings in TEDA are exempted from real estate taxes for 5 years. Buildings transferred to the TEDA are not subject to the transfer tax on real estate. Wages and social costs are 150% deductible for the first year, and new expenses for wages and social costs compared to the previous year are 150% deductible for the subsequent year. Training costs are doubly deductible for a period of 10 years. Research and development costs are doubly deductible for 10 years.
Bosnia and Herzegovina	<ul style="list-style-type: none"> Users of free zones do not pay VAT and customs duties on equipment that will be used for production (Note: This incentive is prescribed by law but de facto is not yet effective) Entities offer their own specific incentives, such as corporate income tax reductions in the Federation for re-investment (30-50% of corporate tax per fiscal year) or tax exemptions based on the creation of workplaces in both entities (the Federation and Republika Srpska). Excise exemption for goods intended to be exported
Former Yugoslav Republic of Macedonia	<ul style="list-style-type: none"> Investors in economic zones are entitled to a 10-year profit tax exemption (otherwise, 10% corporate tax rate applies). Zones offer a 100% reduction of personal income tax for 10 years (otherwise, 10% personal income tax rate applies). Investors are exempt from payment of value-added tax on goods, raw materials and equipment (18% elsewhere). Exemption on customs duties for goods, raw materials, equipment and machines (5-20% elsewhere). Investors are exempt from paying utility taxes to the local municipality or fees for land building permits.
Kosovo	<ul style="list-style-type: none"> No taxes on imports for all goods that are used as inputs in the zones and the date for the payment of customs duties will be prolonged until the moment that the production is finished. All goods getting out of the zones for export/ re-export will be excluded of custom duties. Deferred VAT payment on selected plant machinery.
Montenegro	<ul style="list-style-type: none"> Customs duties and VAT are not paid for the goods entering the zone no matter what type of imported goods or their purpose in the zone, including goods imported by the operator and users for the construction and maintenance of facilities, infrastructure and equipment. Goods from the zone sent to other parts of Montenegro attract customs duties and VAT and other possible import limitations are applied, but customs duties are only paid on the foreign component. Import restrictions do not apply if the domestic component of the goods makes up more than 50% their value. A 40% reduction in the overall fiscal charges for construction permits to be paid to the Municipality of Bar for all buildings/ construction sites destined to manufacturing activities in the Free Zone. All other general incentives offered by the State to investors (grants for the creation of workplaces, as well as exemption of the payment of social insurance contributions and personal income tax for employing disadvantaged groups).
Serbia	<ul style="list-style-type: none"> Customs duties and VAT are not paid for the goods entering the zone no matter what type of imported goods or their purpose in the zone, including goods imported by the operator and users for the construction and maintenance of facilities, infrastructure and equipment in the zone, and for improving working conditions and development of zone. The transfer of goods from the zone to the other parts of Serbia triggers customs duties and VAT and other possible import limitations, but customs duties are paid only on the foreign component. Import restrictions do not apply if the domestic component of the goods makes more than 50% of their value.
Non-tax incentives	
Albania	<ul style="list-style-type: none"> The package of non-tax incentives includes clean usage and long term lease rights; Provision of various expedited government services; Adequate infrastructure (water, power, communication, sewer and drainage facilities) to the borders of the TEDAs; Promotional support through AIDA and various different ministries.
Bosnia and Herzegovina	<ul style="list-style-type: none"> The zones provide gas, sewage, water, electricity, phone and Internet connections. Domestic and foreign companies can apply for obtaining help for promotion (i.e. grants) for participating in national and international trade fairs.
Former Yugoslav Republic of Macedonia	<p>Investors are offered:</p> <ul style="list-style-type: none"> land in economic zones under long-term lease for a period of up to 99 years at concessionary price; up to EUR 500 000 of the construction costs of users of economic zones depending on the number of the new employees and amount invested; exemption from customs duties for equipment and spare parts used for zone activity (5-20% elsewhere); free connections to the natural gas (where available), water and sewage network; business opportunities analysis: identification of project-specific location factors, cost analysis, identification of supplier base and detailed due diligence; linkages: university linkages, reference company linkages, recruitment agency linkages, and the organisation of meetings with legal advisors and financial partners; a one-stop shop: design and infrastructure approvals, issuing building and operational permits, customs outpost in the zone, and zone infrastructure maintenance and upgrades; aftercare: support with relevant tax and customs issues, assistance with acquiring visas/work permits, co-ordination and support in contacts with other state and local authorities.
Kosovo	<ul style="list-style-type: none"> Exemption from (municipal) fees for business registration. Provision of infrastructure (electricity, gas, water, sewage) and preferential land costs.
Montenegro	<ul style="list-style-type: none"> Goods entering the zone do not have to be submitted to customs and there is no need submit a customs declaration, provided that zone users keep records of imports, exports, use and other changes in the goods' characteristics.

Table 4.2. Tax and non-tax incentives per economy (cont.)

Non-tax incentives	
Serbia	<ul style="list-style-type: none"> • One stop shop administration; • Simple and fast customs procedures (each zone has a Customs Administration Office); • Local subsidies for using free zone infrastructure (community offers low prices and service cost); • A set of services is available to users under preferential terms (transportation, loading, reloading, freight forwarding services, insurance and banking services).

Notes:

In Serbia:

- Exports of goods and services from the zone and imports of goods and services into the zone shall be unrestricted and shall not be subject to quantitative restrictions.
- Goods imported or exported from a free zone are treated as customs goods.
- Control of goods is carried out by the customs authority, and zone users are obliged to ensure the implementation of customs controls as well as keeping proper records of goods.
- Goods from the free zones which are released for free circulation on the territory of the Republic of Serbia, shall be subject to payment of customs duties and other import duties.

In Montenegro, the economic zones refer only to Port of Bar Free Zone. Business zones have also been established in selected areas of Montenegro, which are not considered in this report.

Sources: Ministry of Finance of the Republic of Serbia (undated), *Free Zones of Serbia: The Place for your Investment*, www.usz.gov.rs/files/prezentacijaeng.pdf; Directorate for Technological Industrial Development Zones website, "Incentives", www.dtiz.com/setting-up-a-business/why-invest/incentives/ and "Our services", www.dtirz.com/setting-up-a-business/why-invest/our-services/; Ministry of Foreign Trade and Economic Relations of Bosnia and Herzegovina (2013), "List of available investment incentives to investors in Bosnia and Herzegovina (fiscal and non-fiscal)", www.mvteo.gov.ba/izvjestaji/publikacije/izvjestaji/Archive.aspx?langTag=en-US&template_id=96&pageIndex=1; FIPA (undated) "Incentives for foreign investors", http://fipa.gov.ba/informacije/povlastice/strani_investitori/default.aspx?id=141&langTag=en-US; Port of Bar (undated), "Laws", www.lukabar.me/eng/laws.htm.

Chapter 5

Direct economic impacts and spillover effects of special economic zones

This chapter aims to summarise the key direct and indirect impacts that can be observed from special economic zones in the Western Balkan economies so far. It measures direct impact in terms of cumulative investment, number of employees, turnover and exports from the zones as a more rigorous assessment is constrained by data availability and is beyond the scope of this study. The chapter then considers the emerging evidence of spillover effects including labour mobility and education, vertical linkages, regulatory procedures and infrastructure improvements, competition, and imitation.

5.1 Direct impact

Since their establishment, special economic zones in Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Montenegro and Serbia have attracted almost 400 foreign companies and a cumulative investment of over EUR 2.5 billion. Serbia's zones are by far the largest recipients of foreign direct investment (FDI), attracting EUR 2.2 billion as of 2015, EUR 1 billion of which is related to Fiat Automobiles Serbia's (FAS) investment in Kragujevac. The Former Yugoslav Republic of Macedonia comes a distant second, with a total of EUR 207 million of foreign investments directed to its special economic zones during the period 2011-15 (Table 5.1).

Table 5.1 Key indicators for the special economic zones in the Western Balkans

Economy	Total number of zones	Number of active zones ¹	Size (ha)	Number of enterprises	Cumulative zone investment (EUR million)	Number of employees	Total turnover 2015 (EUR million)	Zone exports as % of total exports
Albania	3	0	494 (planned)	0	0	0	0	0
Bosnia and Herzegovina	4	4	79.5	95	n/a	1 700	303	6.4
Former Yugoslav Republic of Macedonia	15	6	893	23	207	6 800	1 475	36.4
Kosovo	3	0	530	0	0	0	0	0
Montenegro	1	1	130	36	5	398	7.6	n/a
Serbia	14	10	1 615	241	2 240	22 242	2 431	17.6

Notes:

1 Active zones are zones with a fully established legal, institutional and management structure and which are broadly investment-ready (basic infrastructure and main services to be offered are in place, etc.), with active enterprises operating in them.

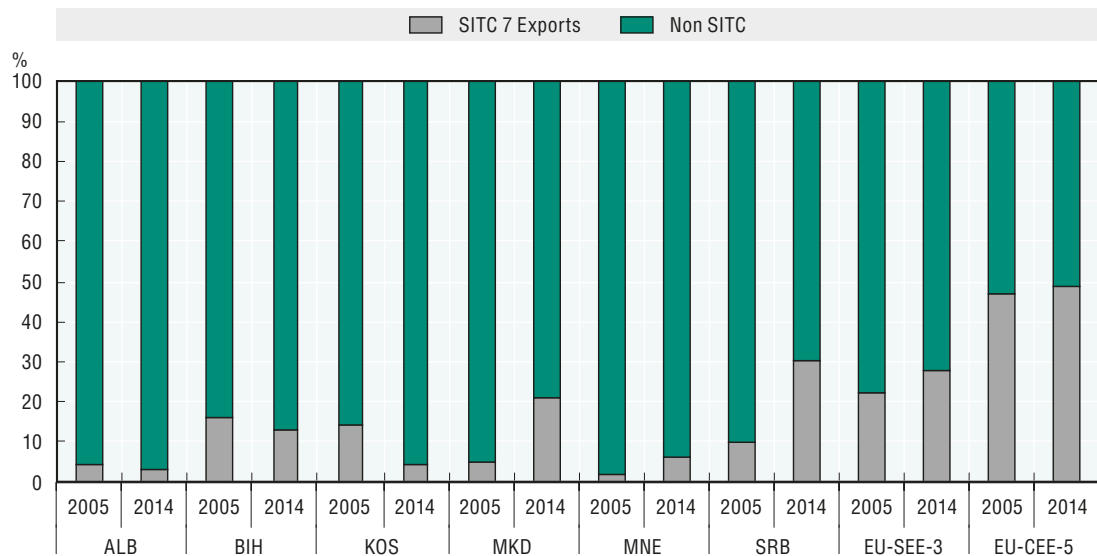
2 Cumulative investment is calculated as the simple sum of investments since the zones' establishment (with the exception of the Former Yugoslav Republic of Macedonia which covers the period from 2011 to 2015), and does not account for capital depreciation.

3 Data for Bosnia and Herzegovina refer to 2014, whereas total turnover for the Former Yugoslav Republic of Macedonia is estimated from the share of total exports for 2015.

Source: Data from zone authorities compiled by the OECD and OECD calculations based on national statistics.

Since most zone enterprises are subsidiaries of multinational companies and are largely suppliers for the automotive industry, their output is almost entirely export oriented. As such, the zones' contribution to total exports is significant: from 6.4% in Bosnia and Herzegovina, to 17.6% in Serbia and 36.4% in the Former Yugoslav Republic of Macedonia (in 2015). Being mostly manufacturing-oriented, the contribution of the special economic zones to manufacturing exports of the countries is even larger: 6.8%, 24.2% and 45% in Bosnia and Herzegovina, Serbia and the Former Yugoslav Republic of Macedonia, respectively. In addition, since the zones in the Former Yugoslav Republic of Macedonia and Serbia account for nearly all automotive manufacturing in the region, the zone investments in these two economies have contributed to the improvement of the structural composition of exports toward the higher value added products related to the automotive industry (Figure 5.1). Last but not least, the zones have also made notable contribution to employment. Companies active in the special economic zones have generated more than 22 000 jobs in Serbia, 6 800 in the Former Yugoslav Republic of Macedonia and about 1 700 in Bosnia and Herzegovina thus far.

Figure 5.1. Exports of machinery and transport equipment as a percentage of total goods exports, 2005 and 2014



Note: SITC – Standard International Trade Classification; SITC group 7 – Machinery and transport equipment
 Source: wiiw Annual Database (2016), <http://data.wiiw.ac.at/annual-database.html>.

5.2. Spillovers

Beside the aforementioned direct effects of increased investment, (higher-value added) exports and the creation of new employment, nascent evidence exists of some positive spillovers from the zone investments.

Labour mobility and education

Workers employed by foreign companies may be subject to formal training and gain experience from working in highly productive environments. This knowledge can then be transferred when a worker leaves and joins a domestic company. Enterprises might also establish connections with vocational/high-schools and/or universities, in order to complement theoretical studies with practical experience and align educational curricula with the needs of the business environment.

Anecdotal experience so far from the Western Balkans appears to confirm some early impacts especially in the area of education. In several cases, companies located in SEZs have started co-operating with training and educational institutions in the area. For example, FAS in Kragujevac (Serbia) has made links with local schools, and promotes scholarships and talent programmes. Van Hool in Skopje (Former Yugoslav Republic of Macedonia) is planning to open a new training centre that will not only be available to its employees, but also to young individuals who are not employed by the company, and who could take their newly acquired skills to a different employer. In the Former Yugoslav Republic of Macedonia, Johnson Controls established a scholarship programme at the Saints Cyril and Methodius University of Skopje, where the company provides financial support to 35 students for a maximum of 4 years, in order to ensure that the skills requirements of the automotive industry are met.

Investors are also working with local universities and technical schools to directly adapt curricula and establish internship programmes, opening training centres and moving research and development (R&D) operations to the region. For example Dunkermotoren in the SEZ of Subotica (Serbia) has established an R&D division in house, employing 12 engineers from Subotica, who perform research for the global company. The company has plans to expand further by building a new 15 000 m² campus within the zone.

Links between academia and business appear to be particularly strong in the engineering field because of the considerable demand for highly qualified workers, which forces companies to compete for a limited number of skilled workers, even before they have completed their studies. Frobias, a German IT company located in the Serbian city of Novi Sad, has strong links to the Faculty of Technical Sciences, regularly hosting interns who may then be hired even while still at university.

Vertical linkages

Foreign companies can create networks and include domestic firms in their production chains, therefore obliging these firms to meet specific criteria and improve the overall quality of their production (“vertical spillovers”). Furthermore, such new markets for domestic enterprises could have a multiplier effect on employment. Cizkowicz et al. (2015) tried to assess the direct and indirect effect of Polish SEZs on employment and investment in 379 Polish counties from 2003 to 2012. Their conclusion was that FDI in SEZs in Poland had a positive impact on employment creation, not only within the special economic zone but also in other regions, while there does not appear to be a strong indirect effect on investment.

In the Western Balkans, there is little evidence of backward linkages. First, most of the zone investors are multinational companies that source the majority of their inputs through bulk purchasing from an already established global supplier network and this is facilitated by the customs and VAT exemptions on imported raw materials and machinery in most WB zones. Moreover, a number of foreign investors attracted or brought along their foreign suppliers to the WB region. This was the case with FAS in Kragujevac, where Fiat-Chrysler brought 21 suppliers to Serbia, 7 of which are located within the SEZ. None of the previous local suppliers of Zastava, the former Serbian car manufacturer, met the quality standards needed to supply their parts to FAS, with the exception of a car-jack producer.

Second, even when there is an interest and potential for reliance on local suppliers, quality and reliability barriers prevent the establishment of such linkages. LK Armatur, a Swedish producer of water-pipe systems for hospitals, which operates a plant with 12 employees in the SEZ of Zrenjanin (Serbia), tried to establish relations with local suppliers in order to cut transportation costs for input material coming from Sweden. However, it found that the quality of the locally sourced goods was inconsistent and that the overall reliability was quite weak due to delays in the production and delivery of the inputs.

As a result, backward linkages remain very limited with the exception of the provision of very basic services unrelated to the production process such as maintenance and plant security, goods with very low added value such as bulk packaging, as well as the use of local suppliers that are already integrated in the global value chains. A notable example of the latter is the Belgian bus manufacturer Van Hool, which opened an assembly plant in the TIDZ Skopje 2 (Former Yugoslav Republic of Macedonia). It relies on local suppliers for metal parts, which had a previous history of exporting goods to automotive manufacturers in Europe and are now supplying not only the Van Hool Skopje plant but the Belgium-based parent company as well.

Regulatory procedures and infrastructure improvements

The establishment of special economic zones is typically coupled with new infrastructure and the optimisation of distribution networks from the manufacturer to the destination markets. These give domestic firms and foreign investors access to better transport and logistics infrastructure and establish new linkages between foreign producers and domestic service providers. Domestic companies can also potentially benefit from intangible know-how and experience of highly export-oriented foreign companies in the field of regulatory compliance and export procedures.

SEZs are usually located in or around existing industrial zones. Therefore, even companies located outside the fenced boundaries of a SEZ benefit from improvements such as newly asphalted roads, better street lighting, parking lots and extended public transportation. The zones can also serve as an important driver for additional funding for local governments either through direct budgetary transfers from the central government or indirectly through the financing of infrastructure projects. Following a relatively weak decentralisation process, most local municipalities in the Western Balkan economies are underfunded, understaffed and have limited capacity to undertake major projects and initiatives aimed at investment attraction and aftercare, so the zones can provide very important benefits in these areas. The zones can also provide an impetus for directing more of the scarce local government resources toward capital investments that favour increased business activity.

For example, in Serbia, which suffered in the mid-2000s from limited public funding and dated infrastructure, the creation of SEZs gave local authorities the opportunity and political backing to direct the available funds towards developing a few core geographical areas where business activity would take place. As a result, certain zones have become the centres of an ever-expanding wider industrial area that attracts considerable non-zone investment due to the well-developed infrastructure, transport and logistic linkages and similar advantages. In Bosnia and Herzegovina, which suffered the devastation of war in 1992-95, the establishment of special economic zones as early as the second half of the 1990s represented an attempt by the authorities to re-establish a reasonable infrastructure that could potentially attract new investors as well as bring back those investors which had been operating there before the break-up of Yugoslavia.

As already mentioned in Chapter 4, investors often prefer zones because the presence of internal customs terminals and simplified procedures allow firms to save time on border formalities as well as to be more flexible in terms of shipping time. These good practices can then be expanded to general customs administration, simplifying trade and customs procedures throughout the country. Where the non-fiscal benefits of the zones are predominant, such as in Serbia, the differences between operating within or outside a special economic zone will tend to gradually disappear, following the gradual improvement and simplification of customs regulations and procedures (such as in-house customs, e-customs and the application of the New Computerised Transit System).

Imitation

Domestic companies can imitate the products of foreign companies, as long as they operate in the same or similar sector and have the technical capacity to do so. In the case of the automotive industry, which represents the most significant form of FDI in the Western Balkans, it is worth noting that the region already had a history with the automotive industry in the former Yugoslavia. Zastava, FAP, Ikarus (Serbia), Tam and Tomos (Slovenia), FAS (Former Yugoslav Republic of Macedonia), FAMOS and TAS (Bosnia and Herzegovina) all produced motor vehicles and components. The economic and political situation in the 1990s led to a severe contraction of the domestic market, coupled

with technological obsolescence due to the forced isolation of some of these economies by conflicts and sanctions for several years. Many of these companies are today on the verge of closure and have undertaken restructuring plans. The large technological gap between domestic companies and SEZ investors in the Western Balkans prevents them from effectively imitating the foreign producers. One telling example is that Zastava Automobiles had been producing the 101/Skala, based on the Fiat 128 model, with minor upgrades, from 1971 and until its full acquisition by Fiat Chrysler Automobiles in 2008: it is hard to imagine that it would have been otherwise able to develop a new model of its own.

Competition

Given that foreign companies are usually more competitive than domestic ones, if they do compete in the domestic market, then they will force domestic enterprises to either improve their productivity levels in order to defend their presence on the market (“horizontal spillovers”), or else exit it, leaving room for more competitive players. In the context of special economic zones, however, additional factors come into play: aggressive incentive policies targeting foreign investors might create unfair market conditions, keeping foreign companies afloat only because of the direct or indirect subsidies, reduced bureaucratic obstacles, and other advantages that render them artificially more competitive than domestic firms.

In light of this, national legislation on SEZs in the Western Balkans have specific clauses on the type of investment allowed in the zones, in order to ensure that enterprises located in special economic zones bring added value to domestic economies, without providing detrimental competition for local enterprises. For example, in the Former Yugoslav Republic of Macedonia, SEZ firms need to carry out activities not previously located in other regions of the country while in Serbia investors must bring new equipment aimed at technology transfer.

The magnitude of spillover effects will vary considerably depending on the nature of the investor, the sector of activity, the nature of domestic enterprises, the general economic environment in which firms operate, the state of infrastructure (both tangible and intangible), and more (Leshner and Miroudot, 2008; Iršová and Havránek, 2013). Foreign companies in Western Balkans’ SEZs and domestic enterprises compete in very different markets, neutralising the potential spillovers that could result from increased competition: foreign firms are massively export-oriented, and the most important ones are full subsidiaries of large foreign enterprises (with the important exception of FAS, though the domestic share is publicly owned), thus limiting the scope for interaction between foreign and domestic management. Western Balkan firms do not usually co-participate in the management of foreign companies, and the technological know-how of local firms is very limited and their size usually small, making it very difficult for them to imitate foreign producers. All this diminishes the potential for positive spillovers which would increase productivity and competitiveness of Western Balkan firms.

The state of both tangible (e.g. the road network) and intangible (e.g. regulations) infrastructure can also affect the degree of productivity spillovers from foreign to domestic companies. Although regulations and legislation in the Western Balkans do not currently present a concrete obstacle to spillovers, neither do they stimulate the establishment of co-operation among foreign and domestic companies.

Evidence from qualitative and quantitative research on the existence and effect of FDI spillovers is conflicting, as it is hard to assess. Leshner and Miroudot (2008) investigated 15 OECD countries and more than 200 000 firms and found that the degree of trade openness of the host country is associated with stronger FDI spillovers. While the ratio of exports to GDP is still low in the Western Balkans (on average, 35% of GDP in the WB, compared to 43% in the European Union), domestically oriented companies struggle to benefit from special economic zones in reaching foreign markets, due to other structural obstacles, such as the technological gap between them and the foreign investors.

Iršová and Havránek (2013) conducted an analysis based on 45 countries and 52 recent empirical studies, in order to assess the spillover impact of FDI. They found on average no spillover effects from FDI, but this conceals very different results across countries, depending upon the characteristics of foreign investors and domestic firms. The creation of foreign-domestic joint ventures and a reduced technological gap between companies leads to higher spillover effects.

Recent studies confirm that, in the specific context of the Western Balkans, the impact of FDI on domestic firms is very limited. Estrin and Uvalic (2016) found that, despite the general contribution of FDI to economic growth in the region, it did not significantly affect manufacturing value added, manufacturing employment or manufacturing exports over the decade 2002-12. The authors claim in the case of the Western Balkans, in contrast to Central and Eastern Europe, one of the reasons for limited spillovers is the predominance of FDI in services compared to manufacturing. Given that SEZs attract mostly manufacturing companies (more than 80% of total FDI in SEZs, compared to 25-40% of total FDI depending on the economy), this might trigger more substantial spillovers in the future.

To conclude, spillovers from SEZs to the rest of the Western Balkans economies have not occurred on a significant scale, or are not yet making themselves felt. This might be because they only started attracting foreign companies on a substantial scale in the past ten years, and mainly in two economies (the Former Yugoslav Republic of Macedonia and Serbia). Thus, it might be too early to assess the impact of their presence on the local labour force and on domestic enterprises benefiting from lessons learned and the presence of foreign enterprises. Increasing linkages between firms operating in the special economic zones and local educational institutions, and introduction of their own formative curricula suggest a larger positive impact than their simple contribution to employment and GDP, but this effect might become apparent only in the longer term.

Chapter 6

Questions for further analysis

This report provides an overview of the special economic zones in the Western Balkan (WB) region focusing on mapping out the zones, their institutional and incentive frameworks, and the key notable impacts and spillovers observed so far. Deeper and more rigorous impact analysis and evaluation of the zone systems is beyond its scope, but the topics covered do give rise to important questions about the effectiveness of the zones as a policy instruments, and it is these questions which are the subject of this chapter.

Have the economic zones been an effective tool for attracting investment into the Western Balkan economies?

To answer this question, one has to consider two separate points: 1) whether the Western Balkan zones have actually made a difference in attracting foreign direct investment (FDI) to the region; and 2) whether these impacts are sizeable enough to justify the costs of the zones.

Based on the analysis and data provided in this report, it is notable that zones in the WB region have attracted considerable amount of investment and account for a significant share of manufacturing and exports in each economy. One can also observe that the growth in manufacturing FDI and exports (Figure 5.1) was much higher in the countries with the most active zone networks (the Former Yugoslav Republic of Macedonia and Serbia) compared to the other economies in the region. These observations alone, however, are not sufficient to conclude that the zones themselves are an effective tool for attracting FDI. The increase in investment may be due to improvements in the investment climate, changes in the external competitive landscape, industry dynamics and other factors that have nothing to do with the introduction of the zone networks. Thus additional analysis would be needed to examine the impact of the zones on investment after controlling for all of these additional factors, demonstrating any statistically significant impact of the zones themselves.

Such a study would be especially important for Serbia, where incentives in the zones do not differ significantly from the incentives enjoyed by enterprises outside of the zone (see the Serbia SEZs Profile page in the Annex) and thus it is much less obvious that if these zones did not exist, the enterprises currently operating in them would not have actually come to invest in Serbia anyway, because of its other comparative advantages (see Chapter 2). In this context, any of the additional costs associated with opening and maintaining special economic zones would be superfluous.

However, even if the zones are shown to have a positive and statistically significant impact on an economy's investment and growth, this does not automatically mean that they are an effective and desirable tool for attracting investment. First of all, the zones' sustainability needs to be considered: are the zone incentives the single most important factor that keeps investors in that economy and once removed (in most cases incentives have sunset clauses lasting a decade or so) will FDI shift to more cost-competitive locations?

Second, the costs of developing and sustaining zone networks need to be considered and how they compare against the benefits. Zone incentives can entail outright expenditure (such as subsidies and infrastructure) or foregone revenues from tax holidays, credits and so forth. Both fiscal and non-fiscal incentives also have indirect costs related to distorting the competition in the market and potentially hurting the growth and development of promising domestic and foreign enterprises operating outside of the zone regime.

This kind of cost-benefit and sustainability analysis is particularly important for countries like the Former Yugoslav Republic of Macedonia, where zones and their associated incentives appear to have played an important role in attracting manufacturing FDI, so much so that they account for the vast majority of all manufacturing FDI inflows and over one-third of all exports from the economy. The zones have also revived the automotive industry which had been dormant for decades. In this context it is important to assess if all of these benefits, along with the spill-overs from the zones, are sufficient to justify the significant costs that they entail.

Conducting a proper cost-benefit analysis is challenging as estimating both the costs and benefits can be quite complex. Many of the benefits of the zones, especially the indirect spill-overs such as technological transfers and skills upgrading, can be quite difficult to quantify and thus easily underestimated. The indirect costs, such as the negative impact on non-zone enterprises from unfair competition, can also be hard to

define. It can be argued that if the zones are shown to have a direct impact on attracting FDI, then the foregone revenue argument is no longer relevant because tax revenues would also be zero if the investment was not made at all. That said, one can still argue that the opportunity cost of that foregone revenue, which could have been used for funding schools or training programmes etc., should still be considered. Estimating these opportunity costs is another challenge. Thus a dedicated study and assessment for each economy would be needed to effectively examine the effectiveness of the zone policies.

If the zones are an effective policy tool, are they optimally designed?

This question basically asks if economies are effectively minimising the costs associated with their zone networks while maximising their benefits. Have the incentives schemes been effectively designed to both minimise their distorting impact on the economy and their negative impact on the budget, whilst maximising the benefit of FDI attraction?

Not all incentives are created equal. Some, such as low corporate tax rates or the provision of good infrastructure and services in the zone territories, are much less distorting than measures such as exemptions from labour taxes and contributions or employment subsidies. A follow-up study might take the typology of zone incentives in Table 4.2 and evaluate the incentive mix based on their distorting effects and their impact on the budgets of each economy. The study could also look at the choice of incentives in light of the types of investments that the zones attract: are the zones predominantly focusing on incentives that offer temporary relief from taxation or other costs and thus risk losing investors when these incentives expire? This relates to the types of investment attracted and how strongly those investments are rooted to a particular geographic location; for example, in general, more capital-intensive investments tend to be more sustainable than labour-intensive ones.

The study could also look at the extent to which zone policies are also seeking to maximise the positive impacts from the zone investments. For example, one of the main potential benefits from the zones, apart from FDI in general, is their potential to boost the domestic economy's linkages with global value chains and the resulting technological upgrading and structural transformation. So the study could examine the extent to which zone policies have been designed to facilitate and encourage the establishment of supplier linkages between the predominantly foreign investors in the zones, which are part of the global value chains, and domestic small and medium-sized enterprises (SMEs), which generally are not. The study could also examine the main barriers to the establishment of these supplier linkages and note how the governments' policies (zone or otherwise) seek to, or should seek to, address those constraints.

The study can also examine whether policies have been put in place to encourage human capital-related spillovers via internships, training, and other means. Finally, it could investigate if the zone incentives and services are optimally targeted: for example aimed at investors in sectors where the region has a comparative advantage, sectors with high value added and technology intensity, and capital-intensive sectors that tend to attract more sustainable investments.

How can the Western Balkan economies co-ordinate with each other to avoid a race to the bottom?

Recent trends point to increased competition between the Western Balkan economies over the attraction of foreign direct investment. Zone incentives and policies are proving to be one of the main instruments through which this competition is intensifying. Serbia is considering introducing additional tax-based incentives to stave off competition from the relatively wider incentive policies offered in the Former Yugoslav Republic of Macedonia. Albania and Kosovo, relative newcomers in the area of zone policy, are likely to add further competitive pressure in this area. These developments have naturally

raised concerns about the triggering of an incentive-based race to the bottom, which will have a detrimental impact on all economies in the region and beyond.

According to the OECD (2003b), when FDI incentives are only introduced to offset those available in other jurisdictions, in most cases the result will be a waste of resources. From this perspective, articles 107 and 108 of the Treaty on the Functioning of the European Union (see Chapter 3 for further discussion), aim to avoid unfair competition to attract FDI, setting common ground and common rules in this area. The SAA stipulations on alignment with EU state aid rules represent a starting point for defining a broader level playing field and basic rules that cap that amount of FDI incentives each WB economy can provide to potential investors.

In addressing the issue of tax co-ordination across countries, the OECD (2015b) agrees that “co-ordinated response can prevent mutually harmful outcomes induced by uncoordinated tax design, e.g. by agreeing on a ban to the use of certain tax incentives”. In the case of FDI, these agreements might not only encompass tax incentives, but other widespread forms of state aid, such as direct grants and the supply of land, goods, services and more.

Co-ordination policies at regional and supranational level can be both binding and non-binding, depending on the level of co-operation and countries’ intentions. Usually, it is good practice to build progressive harmonisation systems that will allow affected countries to avoid the detrimental effects and negative spillovers springing from unlimited competition on investment incentives. A study or a policy paper could examine good practices in regional co-operation on investment. Such a study could not only propose concrete areas where such collaboration can be put in place, but also possible platforms or vehicles through which it can be implemented.

Conclusion

Special economic zones are becoming an ever more important instrument for attracting investment in the Western Balkan region. As the number of zones increases and as more economies begin to use them, the risk of increasing incentive-based competition for investment rises considerably and so does the risk of detrimental impact for all economies concerned. By providing an overview of the current state of zone development in the region and by raising key questions for follow up study, this report seeks to shed more light on SEZs in the region and to spark a debate among policy makers about their value, effectiveness and impact on competitiveness and growth.

As the report has noted, the zones in the WB SEZs have not been created to serve as safe havens in an otherwise highly challenging investment environment. Most WB economies have made considerable strides in improving their overall investment climate. The region also has many competitive advantages beyond the incentives that zones offer, such as its close geographical proximity to the large EU market, free trade agreements with the EU and other large economies such as Russia and Turkey, low tax rates, and cheap skilled labour. In this context, policy makers need to reconsider what value is added by separate investment enclaves where investors enjoy a different set of rules and incentives than the rest of the economy. In particular, policy makers should justify why those incentives cannot or should not be extended to enterprises in the entire economy. They should also consider the potential losses (the so-called deadweight losses) of providing fiscal and other incentives to investors who might have invested in the economy regardless.

In the context of growing intra-regional competition for investment as well as ongoing competition from some EU member states (such as Bulgaria and Romania), it may very well be the case that zone incentives are the decisive factor that brings investors to the region. In this context, as was noted in more detail in Chapter 6, policy makers should weigh the benefits of the zones – in terms of investment and their spillovers to the domestic economy – against the costs of developing them, and all the associated tax and non-tax incentives. This evaluation should consider whether the investments are sustainable or not, especially the risks of companies moving on to more cost-effective locations shortly after the SEZ incentives are removed. The cost effectiveness of the zones should be measured against other potential policy instruments.

Last but not least, the potential adverse impacts from an accelerating incentive-based regional competition for investment warrant an intensified regional dialogue on this issue. As the report has noted, in this pre-accession phase, the WB economies are not bound to adhere to a specified set of incentives for investment attraction so long as they do not exceed EU state aid limits. This creates scope for the implementation of highly distorting incentives which can have a negative impact on domestic and international competition and can lead to unsustainable investments. This also opens up the potential for beggar-thy-neighbour policies whereby economies try to outbid each other with respect to the incentives offered in the zones, which is to the benefit of investors but to the detriment of the economies themselves.

Regional dialogue should tackle investment policies from two angles: 1) preventing a detrimental race to the bottom; and 2) strengthening regional co-operation to boost the region's overall attractiveness for investment. On the first point, the discussion should focus on the types and levels of incentives each economy offers within and outside of the zones. On the second point, the dialogue should focus on challenges related to regional integration. Stronger transport, energy, trade and investment linkages between the regional economies can improve the competitive position both of the individual economies and the region as a whole.

Annex A: SEZs profiles

Albania

There are three active free economic zones in Albania, officially **Technical and Economic Development Areas (TEDAs)**. Supervision of the zones falls under the Ministry of Economy, which selects the private developers and managers for the single zones through a public tender.

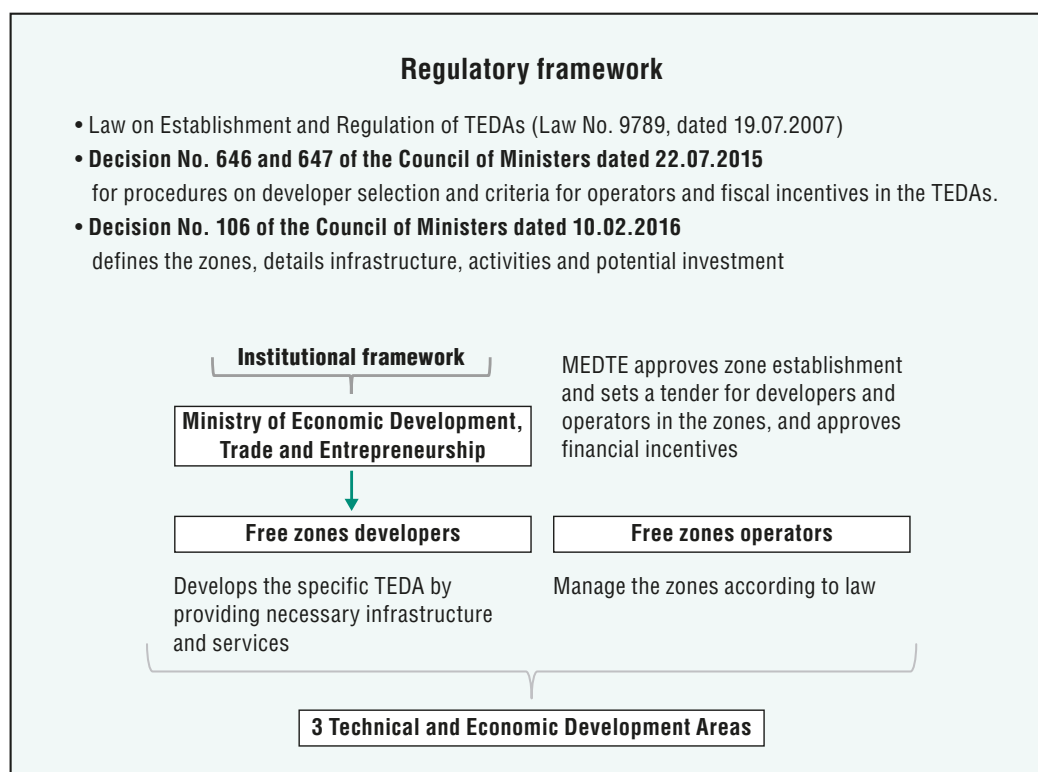


Table A.1. Types of incentives in Albania

Incentives	Awarded aid	Eligibility criteria	Condition for use of aid	Length of incentives	Zone specific
No VAT on machinery	0% VAT.	Machinery costing >EUR 360 000.	The machinery must be targeted at increasing productivity	n/a	No
No excise on fuel	0% excise.	For oil-producing companies.	No further conditions	n/a	No
No VAT on import of cement and steel	0% VAT.	Aimed at construction of hydropower plants.	No further conditions	n/a	No
Assisted administrative procedures and red-tape reduction	n/a	<ul style="list-style-type: none"> • Investment in a "strategic sector": power and mining industry, transport, electronic communications, infrastructure and urban waste, tourism, agriculture. • Investments above EUR 100 million. 	<ul style="list-style-type: none"> • In the power and mining industry an investment must be >= EUR 30 million/50 million. • In the transport, electronic communications infrastructure and urban waste industry an investment must be >= EUR 30 million/50 million. • In the tourism (tourist structures) industry an investment must be >= EUR 5 million and create at least 80 jobs or >= EUR 50 million. • In the agriculture (establishment of a large agricultural farm model) and fisheries an investment must be >= EUR 3 million and create at least 50 jobs or >= EUR 50 million. For the sector «economic areas», including its sub-sectors investment must be >= EUR 5 million/50 million. In the development priority areas an investment must be EUR 1 million and create at least 150 jobs or EUR 10 million and create at least 600 jobs. 	n/a	No
Expropriation of immovable assets, and private property, for the development and execution of the strategic investment project					

Table A.1. Types of incentives in Albania (cont.)

Incentives	Awarded aid	Eligibility criteria	Condition for use of aid	Length of incentives	Zone specific
Exemption from customs duties and VAT on importing foreign goods	No custom duties and VAT exemption for all foreign goods imported in a free zone.	Being a company registered in a TEDA.	Undertake import activities of foreign goods.	n/a	Yes
VAT free	No VAT on Albanian goods aimed at TEDAs.	Being a company registered in a TEDA.	Import Albanian goods into a TEDA	n/a	Yes
20% deduction on capital expenditure	20% deduction on capital expenditure within 2 years.	Being a company registered in a TEDA.	Users and developers who invest in a TEDA within 3 years of its formation.	2 years	Yes
50% reduction on profit tax rate	50% reduction on 15% profit tax rate for 5 years.	Being a company registered in a TEDA.	Making profits.	5 years	Yes
Exemption from infrastructure taxes	No infrastructure taxes on new projects.	Being a company registered in a TEDA.	Building infrastructure within a TEDA.	n/a	Yes
Exemption from real estate taxation	No taxes on real estate.	Being a company registered in a TEDA.	Building new real estate in a TEDA.	5 years	Yes
Exemption from real estate transfer taxation	No transfer taxation on buildings.	Being a company registered in a TEDA.	Buildings must be transferred to a TEDA.	n/a	Yes
150% deduction of wages and social contributions	150% deduction of wages and social contributions for the first year, and subsequent new expenses compared to previous year also deductible by 150% in subsequent years.	Being a company registered in a TEDA.	Hiring workers during activity in the TEDA.	n/a	Yes
200% deduction of training costs	200% deduction of training costs for employees.	Being a company registered in a TEDA.	Providing training to employees.	10 years	Yes
200% deduction of R&D expenditures	200% deduction of R&D expenditures.	Being a company registered in a TEDA.	Conducting R&D activity.	10 years	Yes

Bosnia and Herzegovina

There are **four active free economic zones** in Bosnia and Herzegovina, all of them in the Federation. Three of them function as fully private organisations, whilst the Visoko Free Zone is operated under a PPP arrangement. The zones house **around 100 companies**. These zones account for **6% of all country exports**; employ more than **1 700 people**, and had a combined turnover of about EUR 300 million in 2014.

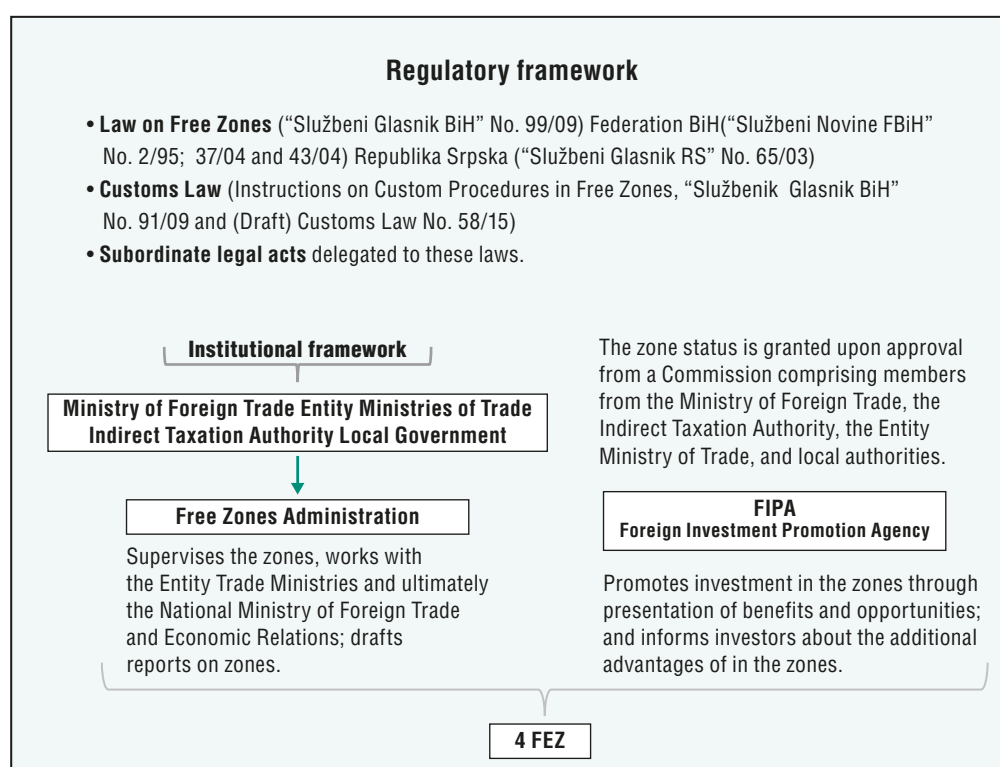


Table A.2. Special economic zones in Bosnia and Herzegovina (2014)

Special economic zone	Area (in hectares)	Number of users	Main operating industry	Number of people employed	Total exports (EUR millions)
Hercegovina	43.6	41	Metallurgy	to be obtained	22
Visoko	17.1	23	Textile	~1000	228
Vogošća	11	30	Automotive	~500	24
Lukavac	7.5	1	Wood processing	190	7

Table A.3. Type of incentives (fiscal and non-fiscal) in Bosnia and Herzegovina

Incentives	Awarded aid	Eligibility criteria	Condition for use of aid	Length of incentives	Zone specific
Value-added tax exemptions in free zones	Exemption from VAT on goods imported into the zone for production purposes.	Be a domestic or foreign company registered and operating in BIH.	Located in the zone and undertaking trading activities.	No limitation while in the zone.	Yes, but not applied
Customs duty exemptions for companies registered in a free zone	Customs-free imports of raw material and semi-finished goods, as well as imports of machinery and equipment.	Be a domestic or foreign company registered and operating in BIH.	Be a domestic or foreign company registered, established and operating in one of Bosnia and Herzegovina's free zones.	n/a	Yes
(General) custom duty exemptions	Customs-free imports of machinery and equipment (with the exception of passenger vehicles and slot machines).	Be a foreign company registered and operating in BIH.	Investment to be made by the foreign firm.	n/a	No
	Customs-free imports of all equipment and machinery to be used for reconstruction and renovation purposes.	Be a domestic or foreign company registered and operating in a BIH.	n/a	n/a	No
	Customs-free imports of raw material and semi-finished goods, as well as imports of machinery and equipment.	Be a foreign company registered and operating in BIH.	Move production lines to Bosnia and Herzegovina from a third country.	n/a	No
	Customs-free imports of equipment and goods.	Be a domestic or foreign company registered and operating in BIH.	Goods and equipment to be used solely for trade and promotion purposes.	n/a	No
	Excise exemption for all export goods.	Be a foreign company registered and operating in BIH.	Undertake export activities.	n/a	No
Aid for participation in trade fairs	Economic support for companies intending to participate in national and international trade fairs.	Be a domestic or foreign company registered and operating in a BIH.	Participate in national and international trade fairs in the company's sector.	n/a	No
Federation BIH					
Tax exemptions after re-investment in the Federation	30% reduction in corporate income tax for the pertinent fiscal year.	Be a foreign company registered and operating in FBiH.	Re-invest at least 50% of profit in production equipment and machinery.	Per fiscal year	No
	50% reduction in corporate income tax for a period of five fiscal years.	Be a foreign company registered and operating in FBiH.	Invest a minimum of BAM 20 million (Bosnian marks) in the Federation over 5 years, with an initial investment of at least 4 million BAM.	5 fiscal years	No
Tax exemptions based on the creation of new workplaces	Chance to claim tax deductions of twice the annual gross salary of each new employee.	Be a domestic or foreign company registered and operating in FBiH.	Provide a full-time contract lasting at least 12 months AND certify that the worker has not previously worked or has links with the company over the previous five years.	12 months	No
Republika Srpska (RS)					
Tax exemptions based on the acquisition of property	Corporate income tax deductions.	Be a foreign company registered and operating in RS.	Real estate or property acquired to be used for the production/working needs of the company.	n/a	No
Tax exemptions based on the creation of new workplaces	Corporate income tax deductions.	Be a foreign company registered and operating in RS.	Employ at least 30 new employees, providing permanent, full time contracts for a minimum of one year.	12 months	No

Former Yugoslav Republic of Macedonia

There are 8 active free economic zones in the Former Yugoslav Republic of Macedonia, the majority of which are publicly operated (the exception being one PPP in Tetovo). The zones house 21 foreign and 2 domestic companies. These zones produced 31% of all exports in 2014.

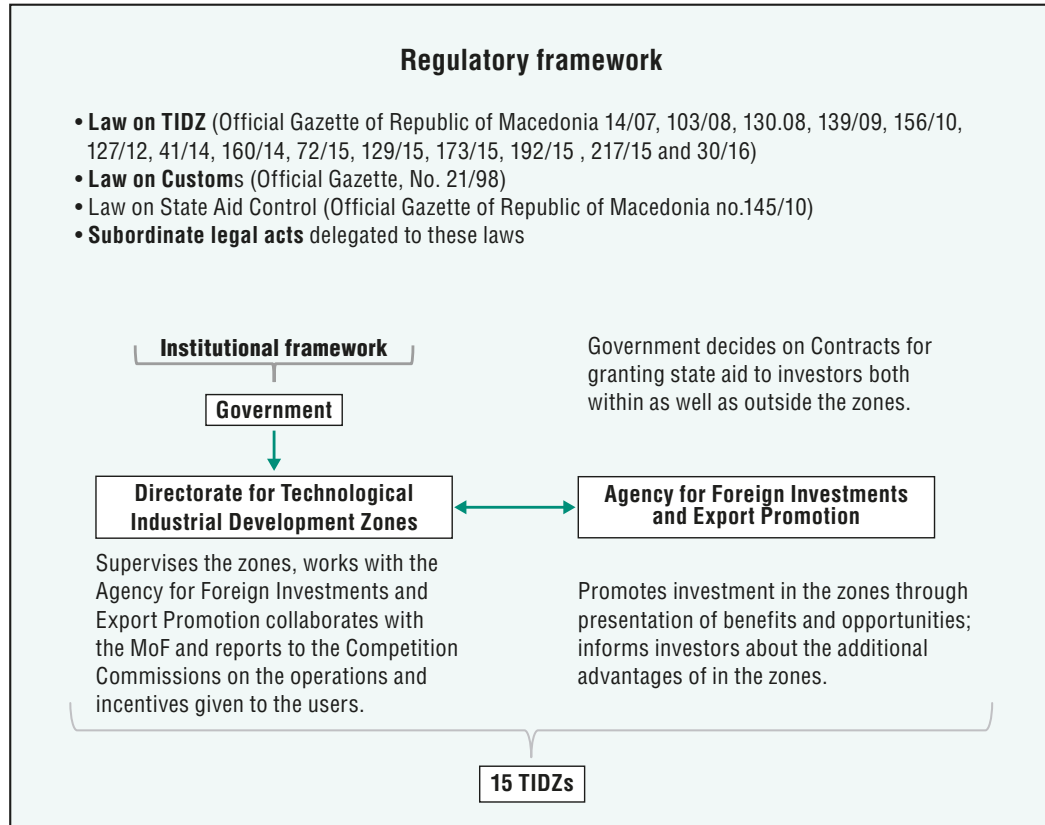


Table A.4. Special economic zones in the Former Yugoslav Republic of Macedonia

Special economic zone	Area in hectares	Number of enterprises	Main operating industry	Cumulative investment (EUR millions)
Skopje 1	140	12	Automotive	208
Skopje 2	97	1	Automotive	25
Skopje 3	44	n/a		
Stip	206	3		12
Tetovo	95	1		
Prilep	67	2	Automotive/ Plastics	20
Struga	30	2		
Strumica	25	1		
Kichevo	30	1	Electronics/Cables	15
Gevgelija	50	n/a	Automotive	15
Berovo	17	n/a		
Delchevo	21	n/a		
Radovis	10	n/a		
Rankovce	40	n/a		
Vinica	21	n/a		

Table A.5. Types of incentives in the Former Yugoslav Republic of Macedonia

Incentives	Awarded aid	Eligibility criteria	Condition for use of aid	Length of incentives	Zone specific	
Tax exemptions from profit tax	Total exemption from profit tax rate, currently at 10%.	Being a domestic or foreign company registered and operating in Technological Industrial Development Zones (established to host high-tech clean industry production that is export-oriented).	Be located in the zone.	10 years ¹¹	Yes	
Tax exemptions from personal income tax	Total exemption from personal income tax rate, currently at 10%.			10 years		
Lower rents	The beneficiaries of TIDZs pay significantly low rent given the area of the parcels.			n/a		
Grant for construction	The amount of aid for construction in TIDZ is limited to EUR 0.5 million. The beneficiaries of the zones use this aid in the form of a grant under the conditions specified in the Law on TIDZ.		Be located in the zone	n/a		
Exemptions from a compensation for organising the construction land (communal taxes)	Exemption from local compensation, determined by the municipality in which the TIDZs are located.			n/a		
Aid for training employees	Zone beneficiaries can receive aid in the form of a grant for training of the employees in the amount of 50% of the eligible training costs for general trainings or 25% of the eligible training costs for general trainings/developments.			Be located in the zone.		n/a
Exemption from paying VAT	Zone beneficiaries are exempt from paying VAT on supply of goods and services in TIDZs (except the supply intended for the final consumption) and import of goods into TIDZs (provided that the goods are not intended for final consumption)., under the conditions specified in the Law on TIDZ.					n/a
Customs duties for specific equipment, machines and spare parts, exemption.	Exemption from paying customs duties for equipment for performing the activity in the Zone, machines and spare parts, under the conditions specified in the Law on TIDZ.		n/a			

Kosovo

There are **three economic zones** in Kosovo. Zones are established upon the request of the municipality to the Ministry of Trade and Industry, and are administered by the municipality. Business organisations or business associations can also submit request for establishment to the ministry or to the municipality.

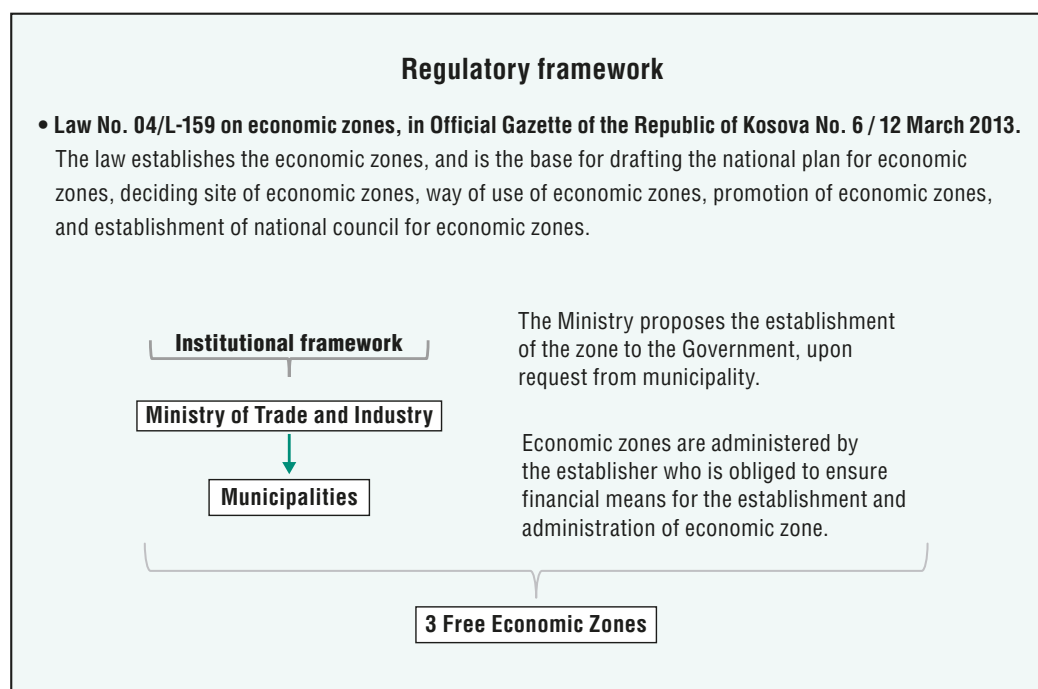


Table A.6. Types of incentives in Kosovo

Incentives	Awarded aid	Eligibility criteria	Condition for use of aid	Length of incentives	Zone specific
Deferred VAT payment on selected plant machinery.	Deferred payment of VAT on imports of selected plant machinery.	Yes	Import plant equipment and machinery.	Up to 6 months	No
Additional 10% deduction on heavy equipment.	Additional deduction allowance of 10% on top of normal depreciation of the cost of acquisition of heavy equipment (production lines for plant and machinery) and heavy transport vehicles.	Only permitted for "heavy" equipment and vehicles. Applicable for new assets or assets first placed in service in Kosovo. Only allowable on assets first used up to 31 December 2012 (note, both income tax usage period is extended to 31 December 2014).	Acquisition of equipment and vehicles under the category.	n/a	No
No customs duty on machinery and raw material.	Exemption from custom duties on machinery and raw material.	The Law on 0% duties was in the Parliament in 2013 – before these incentives were provided based on UNMIK Regulation NO. 2007/31 PART C.	The exempt material must be aimed at manufacturing.	n/a	No
No fees on business registration (Municipality of Suhareka).	Exemption from fees of businesses registration that are involved in production.	Manufacturing businesses.	Business must be located in Suhareka.	n/a	No
Free use of municipal land in Peja.	Free use of municipal land for business activities.	No specific criteria.	Conduct a new business.	Up to 30 years	No

Montenegro

There is only **one active free zone** in Montenegro located on the territory of the Port of Bar. It houses 36 companies, 15 of which are foreign investments.

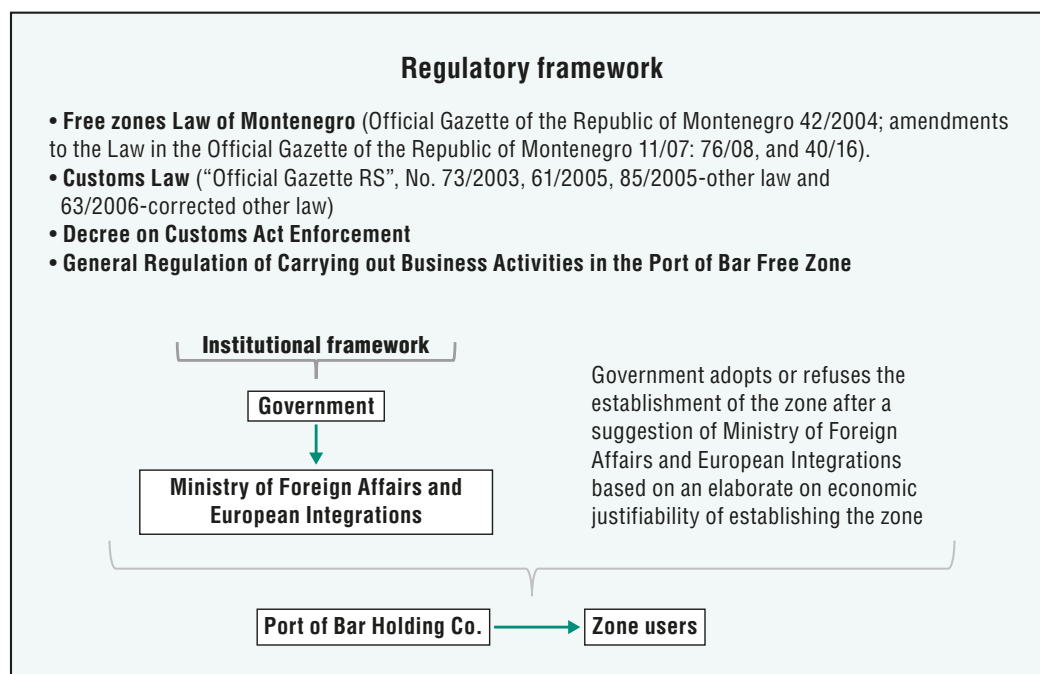


Table A.7. Special economic zones in Montenegro

Free Zone	Area in hectares	Number of enterprises	Main operating activity	Number of people employed	Total turnover in EUR millions
Port of Bar	130 ha (2013; with possibility of expansion)	36	Storage and transshipment	398	7.6

Table A.8. Types of incentives (fiscal and non-fiscal) in Montenegro

Incentives	Awarded aid	Eligibility criteria	Condition for use of aid	Length of incentives	Zone specific
Decree promoting direct investment in Montenegro	Grants ranging from EUR 3,000 to EUR 10,000 per job created depending of the score obtained in the evaluation criteria.	Any foreign investor establishing a business entity in Montenegro	Minimum Investment Value of EUR 500,000 and which ensure at least 20 new jobs within three years from the date of conclusion of the Use of Funds Agreement	One-off payment	No
Subsidies for employment of certain categories of unemployed persons	Exemption of paying contributions for compulsory social insurance on wage earning and personal income tax.	Being a domestic or foreign company registered in Monenegro	Hire certain categories of disadvantaged population (over 40s, Romas, Ashkalis or Egyptians, long-term unemployed).	For the duration of the contractual engagement with the employee.	No
Avoiding double taxation	Montenegro signed 42 treaties (36 in force, 6 pending) regulating double taxation of income and property with various countries.	Being a domestic or foreign company registered and operating in Montenegro.	Operating in one of the 36 countries that has a treaty with Montenegro in force.	n/a	No
Customs duty exemptions	Customs duties are not paid for the goods entering the zone no matter the type of imported goods or their purpose in the zone.	Being a domestic or foreign company registered and operating in the zone.	Operating in the zone.	No limitation while in the zone	Yes
VAT exemptions	VAT is not paid on goods entering the zone no matter the type of imported goods or their purpose in the zone.				
Goods entering the zone are not liable to foreign-trade restrictions (permits, quotas etc.)	No foreign-trade restrictions.				
Goods stored in the zone are allowed to stay for unlimited period of time	Unlimited period of time.				
Goods may be temporarily taken in and out of the zone.	Goods may be temporarily taken from the zone into the rest of Montenegro or enter the zone from the rest Montenegro for the purpose of improving, assembling, testing, repairing, marketing presentation etc. Goods entering the Montenegrin custom territory from the zone with commercial purposes are subject to the payment of customs, custom duties and value added tax – yet only for the foreign components present in them.				
Capital Investments	Capital investments in the zones, its derived transfer of profits and role are tax-free.				
Payment of Fiscal Charges for construction sites	Overall reduction of 40% for all fiscal charges relating to construction permits to be paid to be Municipality of Bar for all buildings destined for manufacturing in the Free Zone Port of Bar.				

Serbia

There are **14 active free economic zones** in Serbia, functioning as PPPs between municipalities and (one or more) enterprises. The zones house **240 multinational companies**. These zones currently produce **16% of all exports**; employ more than **22 000 people**, and had a combined turnover of EUR 4.6 million in 2015 (almost double the turnover in 2012).

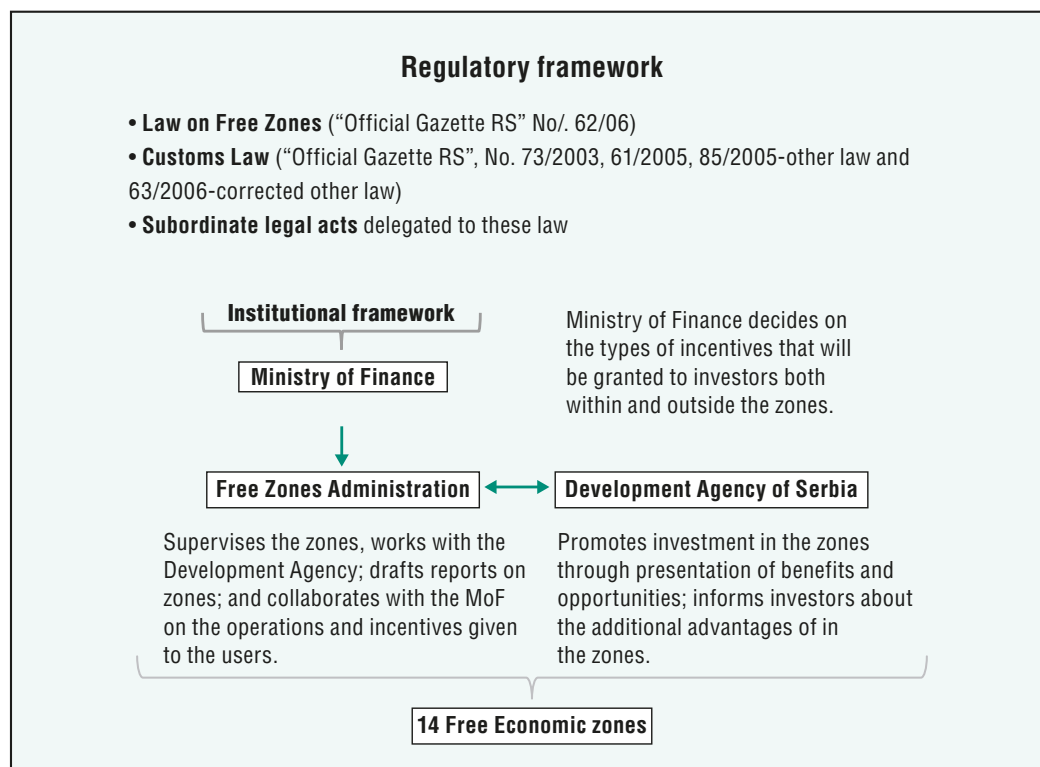


Table A.9. Special economic zones in Serbia

Special economic zone	Area in hectares	Number of manufacturing enterprises	main operating industry	Number of people employed	Total turnover (EUR millions)
Apatin	415	Zone is not fully active	Petroleum	0	0.1
Subotica	44	5	Electrotechnics	3521	622
Zrenjanin	98	5	Plastics	3398	206
Novi Sad	75	6	Petroleum	251	82
Šabac	244	6	Automotive	56	9
Smederevo	143	6	Metal	1363	36
Svilajnac	33	1	Electric works	392	85
Kragujevac	176	7	Automotive	4354	2490
Užice	55	6	Copper	1950	393
Kruševac	64	1	Rubber/Chemical	1150	15
Pirot	116	16	Rubber-Pneumatics	5808	689
Vranje	123	Zone is not active	Footwear	0	0
Beograd	98	Zone is not active		0	0

Note: The table contains the 12 free economic zones in Serbia except the 2 in Belgrade and Priboj for which relevant data is not available. The data are relevant as of the year 2014.

Table A.10. Types of incentives in Serbia

Incentives	Awarded aid	Eligibility criteria	Condition for use of aid	Length of incentives	Zone specific
State grants based on the eligible costs of gross salaries for new jobs.	20-40% for investment projects (depending on the regional level of development) with specific limitations on the amount per new job created.	<ul style="list-style-type: none"> - Investors who have investment projects in sectors that are in accordance with the decree and apply for grants before the start of the realisation of the project. - Investors who can provide a minimum of 25% of eligible costs from their own resources or from other sources, which do not contain any other state grants. 	<ul style="list-style-type: none"> - Large investors are required to demonstrate incentive effects. - Investors are required to maintain investment at the same locations once investment is realised for a specified period of time: at least 5 years after the implementation of the project for large enterprises, or at least 3 years for small and medium-sized businesses. - Investors cannot reduce the number of employees after the implementation of the investment project, over a period of 5 years for large enterprises, and 3 years for small and medium enterprises. - Create at least 20-50 jobs and invest at least EUR 150 000-600 000 of the eligible costs of investment (depending on the regional level of development). 	n/a	No
Increase in state grant based on the amount of eligible investment costs.	Up to 30% increase (depending on the regional level of development).			No	
Increase in state grants for labour-intensive projects.	Up to 20% increase of the eligible costs of gross salaries (for any increase in the number of new jobs created over 200 – 1000 new jobs)			No	
The National Employment Service Grant.	Employment Subsidies Programme (grant amount per employee: EUR 850 – 1,700), Apprentice Programme (grant amount per employee: EUR 170 – 210), Retraining Programme (grant amount per employee: EUR 850)			No	
Corporate Profit Tax Holiday.	Exemption from corporate profit tax for period of 10 years	Being a domestic or foreign company registered and operating in Serbia .	<ul style="list-style-type: none"> - Start reporting taxable profits. - Invest amount exceeding approximately EUR 8.5 million in fixed assets. - Employ at least 100 additional employees. 	10 years	No
Carry forward of losses.	Companies have right to carry forward tax losses in order to pay less taxes on their future profits	Being a domestic or foreign company registered and operating in Serbia.	State losses in tax returns over a period of 5 years.	n/a	No
ding double taxation.	Corporate income tax credit.	Being a domestic or foreign company registered and operating in Serbia.	Pay tax on the profit generated abroad on the already paid amount.	n/a	No
Customs duty exemptions.	Customs-free imports of raw materials and semi-finished goods, as well as imports of machinery and equipment.	Being a domestic or foreign company registered and operating in Serbia.	Undertake import activities.	n/a	Yes, but not mandatory
Value added tax exemptions in free zones.	Exemption from VAT on income generated from commercial activities.	Being a domestic or foreign company registered and operating in Serbia.	Be located in the zone and undertake trading activities.	No limitation while in the zone	Yes
Local tax relief.	City building land and development lease fees exemptions or deductions, as well as other local fee exemptions or deductions.	Being a domestic or foreign company registered and operating in Serbia.	Be located in a specific municipality.	n/a	No

Annex B: The OECD Policy Framework for Investment

The Policy Framework for Investment (PFI) helps governments to mobilise private investment in support of sustainable development, thus contributing to the prosperity of countries and their citizens and to the fight against poverty. It offers a list of key questions to be examined by any government seeking to create a favourable investment climate. The PFI was first developed in 2006 by representatives of 60 OECD and non-OECD governments in association with business, labour, civil society and other international organisations and endorsed by OECD ministers. Designed by governments to support international investment policy dialogue, co-operation, and reform, it has been extensively used by over 25 countries as well as regional bodies to assess and reform the investment climate. The PFI was updated in 2015 to take this experience and changes in the global economic landscape into account.

The PFI is a flexible instrument that allows countries to evaluate their progress and to identify priorities for action in 12 policy areas: investment policy; investment promotion and facilitation; trade; competition; tax; corporate governance; promoting responsible business conduct; human resource development; infrastructure; financing investment; public governance; and investment in support of green growth. Three principles apply throughout the PFI: policy coherence, transparency in policy formulation and implementation, and regular evaluation of the impact of existing and proposed policies.

The PFI adds value by bringing together the different policy strands and stressing the overarching issue of governance. The aim is not to break new ground in individual policy areas but to tie them together to ensure policy coherence. It does not provide ready-made reform agendas but rather helps to improve the effectiveness of any reforms that are ultimately undertaken. By encouraging a structured process for formulating and implementing policies at all levels of government, the PFI can be used in various ways and for various purposes by different constituencies, including by governments to evaluate and design their own reforms and for peer reviews in regional or multilateral discussions. In the context of the Western Balkans, it could assist the region's economies in successfully linking special economic zones to their broader investment strategies.

The PFI looks at the investment climate from a broad perspective. It is not just about increasing investment but about maximising economic and social returns. Quality matters as much as the quantity as far as investment is concerned. It also recognises that a good investment climate should be good for all firms – foreign and domestic, large and small. The objective of a good investment climate is also to improve the flexibility of the economy to respond to new opportunities as they arise – allowing productive firms to expand and uncompetitive ones (including state-owned enterprises) to close. The government needs to be nimble: responsive to the needs of firms and other stakeholders through systematic public consultation and able to change course quickly when a given policy fails to meet its objectives. Governments should also create a champion for reform within the government itself. Most importantly, they need to ensure that the investment climate supports sustainable and inclusive development.

The PFI was created in response to this complexity, fostering a flexible, whole-of-government approach which recognises that investment climate improvements require not just policy reform but also changes in the way governments go about their business.

Investment policy and competitiveness area	Review of Western Balkan policies
Laws, regulation and policies related to the admission of investors	All of the Western Balkan economies have made important improvements in strengthening safeguards of foreign investors' rights: foreign investors are now largely on equal footing to domestic ones, access to land has been facilitated, there are no restrictions on the recruitment of foreign personnel and risks of expropriation are limited. Expropriation is permitted only under strictly defined circumstances and it is generally followed by prompt, adequate and effective compensation in all six economies (OECD, 2016).
Protection of property rights	Property rights have improved in most Western Balkan economies over the past decade following general institutional and judiciary improvements: <ul style="list-style-type: none"> Albania continues to significantly lag behind the rest of the region largely due to a fragmented cadastre system with large gaps and overlaps (WEF, 2016).
Contract enforcement and dispute settlement	This area still represents a major drawback for prospective investors, with some structural problems replicating themselves across all WB economies. In most of the economies, contract enforcement tends to be costly, time consuming and can exacerbate the already acute liquidity problems of many micro and small domestic firms, since payment arrears are hard to claim or are paid after a long time. <ul style="list-style-type: none"> Kosovo stands out with regard to the time needed to enforce a contract, which is significantly below the regional average (World Bank, 2016). The Former Yugoslav Republic of Macedonia and Serbia have better overall quality of judicial processes than their regional peers (World Bank, 2016).
Competition policy	All six WB economies have introduced policies that enable the competition authorities to investigate and impose, or ask the courts to impose, sanctions on firms that exhibit anti-competitive behaviour. These authorities are formally independent (governments have not formulated binding directions on competition enforcement) and have most of the tools and powers they should need to enforce competition law effectively. Nevertheless, systematic implementation remains a great issue across the region. Competition agencies are under-resourced and have to cope with high caseloads (all six WB competition agencies are bound by the principle of legality and consequently have to deal with each complaint that is brought to their notice, which results in a considerable caseload). Stakeholders get limited guidance on the competition authorities' enforcement practices (OECD, 2016).
Trade policy and international agreements	Trade policy is one of the areas where the WB economies have made the most significant progress. The WB economies have signed numerous regional and trade agreements, either bilaterally or by accession to the regional free trade agreement, CEFTA. SAAs and the free trade agreement with EFTA allow WB products to enter the EU customs-free and without quantitative restrictions. Nevertheless, regional trade integration within the CEFTA region has improved only moderately, while trade with the EU and other developed markets is hampered by considerable non-tariff barriers stemming from non-compliance with relevant quality and safety standards. This is also one of the main reasons why the WB economies are also very weakly integrated into global value chains. <ul style="list-style-type: none"> Albania, the Former Yugoslav Republic of Macedonia and Montenegro are also World Trade Organization (WTO) members.
Human resources development	All WB economies share similar issues regarding human capital development potential. Education quality could be improved at all levels in the region, especially when it comes to addressing the needs of the labour market and the private sector. Training capacity and consultancy services are weak in all six economies. As a result, there are few work-based learning schemes (such as apprenticeships and internships) or lifelong learning programmes. Low human capital endowment may be one of the key constraints on strengthening backward linkages if investments are to happen, and it is likely to become an even more pressing problem in the short to medium term. Brain drain represents a serious concern for the region as a whole, with the pace increasing in recent years, followed by the substantial loss of human capital and qualified workforce it entails (OECD, 2016).
Investment promotion and facilitation	All of the WB economies have investment promotion and facilitation frameworks in place, but they do not routinely link foreign investors with potential domestic suppliers. FDI incentive schemes are generally not based on adequate cost-benefit analysis and investor services are not yet sufficiently developed (OECD, 2016). <ul style="list-style-type: none"> One-stop shops have been established in Albania, the Former Yugoslav Republic of Macedonia and Serbia (OECD, 2016).
Other competitiveness factors	Western Balkan economies have made considerable progress in reducing the overall regulatory and administrative burden on businesses. A number of countries have implemented a so-called regulatory guillotine whereby they comprehensively evaluated all licences, procedures and fees applied to businesses. As a result, starting and operating a business is now much easier than it was a decade ago in most regional economies (World Bank, 2016). The region has among the lowest corporate tax levels in Europe. However, the length and complexity of filing taxes still present some problems as well as the numerous, non-transparent, and unpredictable fiscal and para-fiscal charges that businesses face in dealing with local administrations. The latter is a direct consequence of a decentralisation process that resulted in very weak financing mechanisms for the local administration, driving local governments to create ad hoc charges to get additional revenues, placing a considerable burden on businesses. In the case of Serbia, one study found more than 380 non-tax levies, 247 of which were para-fiscal charges. Lack of transparency and oversight from central government facilitates the persistence of such charges (NALED, 2014). Local labour markets still face some important challenges: relatively high unit labour costs, high reservation wages (particularly in the case of Montenegro), and expensive and discouraging social benefit schemes. While employment protection legislation in the Western Balkans has been considerably liberalised over the past ten years, productivity levels remain low due to the general lack of hard and soft skills. Informality is prevalent among less well educated and inexperienced workers, further encouraged by social benefit schemes linked to unemployment which get suddenly withdrawn from workers taking a formal job, even at the minimum wage level, making it inconvenient for both the employer and employee to change the status quo. Sustained social insurance contributions keep labour costs high (despite recent falls in labour taxes) due to the competition to attract FDI (Kovtun et al., 2014). Considerable infrastructure investment has improved connectivity with the region's main trading partners as well as to facilitate business at home. <ul style="list-style-type: none"> Easy and reliable access to electricity remains a challenge in some economies, including Albania and Kosovo. This represents a considerable deterrent to investors, especially large manufacturers: 81% of Kosovan firms experienced on average 13.6 power outages per month, causing losses of 11.3% of total annual revenue. The number of outages was lower in Albania, but firms still experienced annual revenue losses of 7.7% (EBRD, 2015).

Notes

1. This report does not cover industrial and technology parks because SEZs under our definition require provision of a specific regulatory framework and/or incentives regime restricted to the enterprises operating on the pre-defined zone territory.
2. Bosnia and Herzegovina introduced special economic zones following the end of the war in the country, and such zones seem to have attracted significant inflows of investment between the late 1990s and early 2000s. Thus, they cannot really be credited for attracting new investment in the way zones in the Former Yugoslav Republic of Macedonia and Serbia have in the aftermath of the Great Recession.
3. CEB countries in this document comprise the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia.
4. Albania was the only exception to this trend. The country was not affected by the conflicts, sanctions and embargoes that affected former Yugoslavia. It was the poorest country in Europe and its catch-up potential was considerably higher compared to the ex-Yugoslav republics and it benefitted considerably from remittance inflows throughout the 1990s, which were one of the main sources of investment. Still, the country suffered from a severe financial crisis and civil unrest in 1997, following the collapse of a series of pyramid schemes that uncovered the fragile ground on which the state to market economy transition was taking place in the 1990s.
5. Just-in-time strategies pursue increased efficiency by reducing inventory costs: optimally, production goods are only received when needed. Manufacturers, and particularly the automotive industry, thus rely on their supply chains to constantly adapt themselves to the fluctuating needs for parts and components ordered by headquarters, furnishing the agreed deliveries on time and maintaining quality standards.
6. Data on manufacturing FDI are patchy and inconsistent for the Western Balkan economies for this period and so the range presented here is based on calculations from available data for these economies.
7. Even Serbia, which had a managed float exchange rate regime, had to limit its currency's depreciation against the euro due to the high level of euroisation of the financial system.
8. Note: Unit labour cost was calculated as $[(\text{average gross wage} \times \text{number of employed}) / \text{GDP}] \times 100$. In the cases of Albania and Kosovo, average net wage was used due to lack of data on gross wages. One should keep in mind the high discrepancy between ULCs in gross and net wage terms – 12 on average in other Western Balkan economies.
9. Active zones are zones with a fully established legal, institutional and management structure and are broadly investment-ready (basic infrastructure is in place, main services to be offered are in place, etc.), with active enterprises operating in them.
10. The European Commission defines micro, small and medium-sized enterprises as follows: medium-sized enterprises – less than 250 employees with turnover not exceeding EUR 50 million and/or balance-sheet not exceeding EUR 43 million; small enterprises – less than 50 employees and turnover/balance sheet not exceeding EUR 10 million; micro-enterprises – less than 10 employees and turnover/balance sheet not exceeding EUR 2 million.
11. This period (for profit tax and PIT) can be shorter if the maximum intensity of state aid is reached earlier which is in line with the Law on state aid and EU law. This rule also applies for to the other tax/ custom incentives

References

- Appel, H. (2011), *Tax Politics in Eastern Europe: Globalization, Regional Integration, and the Democratic Compromise*, University of Michigan Press, Ann Arbor, MI.
- Bernardi, L., M.W.S Chandler and L. Gandullia (eds.) (2005), *Tax Systems and Tax Reforms in New EU Members*, Routledge, New York.
- Cizkowicz, P. et al. (2015), “The effects of special economic zones on employment and investment: Spatial panel modelling perspective”, *NBP Working Paper*, No. 208, Economic Institute, Warsaw.
- Commission on Growth and Development (2008), “The automotive industry in the Slovak Republic: Recent developments and impact on growth”, *Working Paper*, No. 29, Commission on Growth and Development, Washington, DC, http://siteresources.worldbank.org/EXTPREMNET/Resources/489960-1338997241035/Growth_Commission_Working_Paper_29_Automotive_Industry_Slovakia_Recent_Developments_Impact_Growth.pdf.
- Easson, A. (2004), *Tax Incentives for Foreign Direct Investment*, Kluwer Law International, the Hague and New York.
- Easson, A. and E.M. Zolt (2002), *Tax Incentives*, World Bank website, <http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf>.
- EBRD (2015), *EBRD Business Environment and Enterprise Performance Survey (BEEPS)* (database), European Bank for Reconstruction and Development, <http://ebrd-beeps.com/data/>.
- EBRD (2014), *Transition Indicators 1989-2014* (database), European Bank for Reconstruction and Development, www.ebrd.com/what-we-do/economic-research-and-data/data/forecasts-macro-data-transition-indicators.html.
- EBRD (2010), *Transition Report 2010: Recovery and Reform*, European Bank for Reconstruction and Development, London.
- EBRD (2003), *Transition Report 2003: Integration and Regional Cooperation*, European Bank for Reconstruction and Development, London.
- EBRD (2002), *Transition Report 2002: Agriculture and rural transition*, European Bank for Reconstruction and Development, London.
- EBRD (2001), *Transition Report 2001: Energy in Transition*, European Bank for Reconstruction and Development, London.
- EBRD (1994), *Transition Report: October 1994*, European Bank for Reconstruction and Development, London.
- Estrin, S. and M. Uvalic (2016), “Foreign direct investment in the Western Balkans: What role has it played during transition?”, *Comparative Economic Studies*, Vol. 58/3, pp. 455-483, <http://dx.doi.org/10.1057/ces.2016.10>.
- European Commission (2016a), *Commission Staff Working Document: Bosnia and Herzegovina 2016 Report*, European Commission, Bruxelles.
- European Commission (2016b), *Commission Staff Working Document: The Former Yugoslav Republic of Macedonia 2016 Report*, European Commission, Bruxelles.
- European Commission (2016c), *Commission Staff Working Document: Serbia 2016 Report*, European Commission, Bruxelles.
- European Commission (2008), *Vademecum Community Law on State Aid*, Directorate-General for Competition, http://ec.europa.eu/competition/state_aid/studies_reports/studies_reports.cfm.
- Eurostat (2016a), “Electricity prices by type of user (EUR per kWh)”, *Eurostat* (database), <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=ten00117&plugin=1>.
- Eurostat (2016b), “Labour costs annual data – NACE Rev. 2”, *Eurostat* (database), <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tps00173&plugin=1>.
- Farole, T. (2011b), “Special economic zones: What have we learned?”, *World Bank Poverty Reduction and Economic Management Network (PREM)*, No. 64, World Bank, Washington, DC, <http://siteresources.worldbank.org/INTPREMNET/Resources/EP64.pdf>, (accessed 14 November 2016).
- Farole, T. (2011a), “Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience”, World Bank, Washington, DC.
- Farole, T. and A. Gokhan (eds.) (2011), *Special Economic Zones: Progress, Emerging Challenges, and Future Directions*, World Bank, Washington, DC.
- Farole, T. and J. Kweka (2011), “Institutional best practices for special economic zones: An application to Tanzania”, *Africa Trade Policy Note*, No. 25, World Bank, Washington, DC, <http://siteresources.worldbank.org/INTRANETTRADE/Resources/SEZTanzaniaPolicynoteFinal.pdf>.
- FIAS (2008), *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development*, The World Bank, Washington, DC.
- Figini, P. and H. Goerg (2011), “Does foreign direct investment affect wage inequality? An empirical investigation”, *The World Economy*, Vol.34/9, pp. 1455-1475. <http://dx.doi.org/10.1111/j.1467-9701.2011.01397.x>.

- FIPA (undated), "Incentives for foreign investors", Foreign Investment Promotion Agency of Bosnia and Herzegovina website, http://fipa.gov.ba/informacije/povlastice/strani_investitori/default.aspx?id=141&langTag=en-US
- FIPA (2016), "Slobodne Zone", Foreign Investment Promotion Agency of Bosnia and Herzegovina website, http://fipa.gov.ba/investiranje/lokacije/slobodne_zone, (accessed 1 September 2016).
- Gabrish, H., D. Hanzl-Weiss and M. Holzner (2016), "Improving competitiveness in the Balkan Region: Opportunities and limits", Research Report, No. 411. Wiiw, <http://wiiw.ac.at/improving-competitiveness-in-the-balkan-region--opportunities-and-limits-dlp-3917.pdf>.
- Hazakis, K.J. (2014), "The rationale of special economic zones (SEZs): An institutional approach", *Regional Science Policy & Practice*, Vol. 6/1, pp. 85-101.
- Holzner, M. (2016), "Policy options for competitiveness and economic development in the Western Balkans: The case for infrastructure development", *Policy Notes and Reports*, No. 16, wiiw, <http://wiiw.ac.at/policy-options-for-competitiveness-and-economic-development-in-the-western-balkans-the-case-for-infrastructure-investment-dlp-3916.pdf>.
- IMF WEO (2016), *World Economic Outlook Database*, April 2016 Edition, (database), <https://www.imf.org/external/pubs/ft/weo/2016/01/weodata/index.aspx>. IMF (2014), *Spillovers in International Corporate Taxation*, Policy Paper (May 19, 2012).
- IMF (2016), *World Economic Outlook Database*, April 2016 Edition, International Monetary Fund, www.imf.org/external/pubs/ft/weo/2016/01/weodata/index.aspx.
- IMF (2014), *Spillovers in International Corporate Taxation*, IMF Policy Paper, International Monetary Fund, Washington, DC.
- Iršová, Z. and T. Havránek (2013), "Determinants of horizontal spillovers from FDI: Evidence from a large meta-analysis", *World Development*, Vol. 42, pp. 1-15.
- Jakubiak, M. et al. (2008), "The automotive industry in the Slovak Republic: Recent developments and impact on growth", *Commission on Growth and Development Working Paper*, No. 29, The International Bank for Reconstruction and Development/The World Bank, Washington, DC.
- Klemm, A., Parys, S. (2012), "Empirical evidence on the effects of tax incentives", *International Tax and Public Finance*, Vol. 19/3, pp. 393-423.
- Kisłowska, M (2006). "The Future of Special Economic Zones in the Aftermath of Poland's Accession to the European Union", *Journal of International Business Law*, Vol. 5: Issue 1, Article 7, <http://scholarlycommons.law.hofstra.edu/jibl/vol5/iss1/7>.
- Kovtun, D., A.M. Cirkel, Z. Murgasova, D. Smith and S. Tambunlertchai (2014), "Boosting job growth in the Western Balkans", *IMF Working Paper*, WP/14/16, International Monetary Fund, Washington, DC.
- KPMG (2016), "Corporate tax rates table", KPMG website, <https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html>, (accessed 20 September 2016).
- Leshner, M. and S. Miroudot (2008), "FDI spillovers and their Interrelationships with trade", *OECD Trade Policy Papers*, No. 80, OECD Publishing, Paris, <http://dx.doi.org/10.1787/235843308250>.
- Ministry of Economic Development, Trade and Entrepreneurship (2015), *Technical and Economic Development Areas in Albania: An Opportunity for Investors and Land Developers: Spitalla, Koplík & Vlora*, Technical and Economic Development Areas, www.teda.gov.al/wp-content/uploads/2015/04/veda-revised%20v4.pdf.
- Ministry of Finance and Economy of the Republic of Serbia (undated), *Free Zones of Serbia: The Place for your Investments*, Free Zones Administration, www.usz.gov.rs/files/prezentacijaeng.pdf.
- Ministry of Foreign Trade and Economic Relations of Bosnia and Herzegovina (2013), "List of available investment incentives to investors in Bosnia and Herzegovina (fiscal and non-fiscal)", Ministry of Foreign Trade and Economic Relations website, www.mvteo.gov.ba/izvjestaji/publikacije/izvjestaji/Archive.aspx?langTag=en-US&template_id=96&pageIndex=1.
- Moberg, L. (2014), "The political economy of special economic zones", forthcoming in the *Journal of Institutional Economics*. <http://dx.doi.org/10.2139/ssrn.2297871>.
- NALED (2014), *The System on Non-Tax and Para-Fiscal Charges in Serbia*, National Alliance for Local Economic Development, www.naled-serbia.org/upload/Document/File/2014_01/Study_on_para_fiscal_charges_to_businesses.pdf (accessed 10 November 2016).
- OECD (2016), *Competitiveness in South East Europe: A Policy Outlook*, Competitiveness and Private Sector Development, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264250529-en>.
- OECD (2015a), *Policy Framework for Investment*, 2015 Edition, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264208667-en>.
- OECD (2015b), *Options for Low Income Countries Effective and Efficient Use of Tax Incentives for Investment. Call for Input*, OECD, Paris, www.OECD.org/tax/tax-global/options-for-low-income-countries-effective-and-efficient-use-of-tax-incentives-for-investment-call-for-input.pdf.
- OECD (2012), "Downloadable data", *PISA 2012 Database*, OECD, <http://www.OECD.org/pisa/pisaproducts/pisa2012database-downloadabledata.htm>.

- OECD (2010), *Investment Reform Index 2010: Monitoring Policies and Institutions for Direct Investment in South-East Europe*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264079588-en>.
- OECD (2006), "Export processing zones: Past and future role in trade and development", *OECD Trade Policy Working Paper*, No. 53, OECD, Paris, www.OECD.org/officialdocuments/publicdisplaydocumenpdf/?cote=TD/TC/WP%282006%2939/FINAL&docLanguage=En.
- OECD (2003a), *OECD Economic Surveys: Federal Republic of Yugoslavia 2002*, OECD Publishing, Paris, http://dx.doi.org/10.1787/eco_surveys-srb-2002-en.
- OECD (2003b), *Tax Policy Assessment and Design in Support of Direct Investment: A Study of Countries in South East Europe*, OECD Tax Centre for Tax Policy and Administration, OECD, Paris, www.OECD.org/turkey/34466352.pdf.
- OECD (2003c), *Checklist for Foreign Direct Investment Incentive Policies*, OECD, www.OECD.org/investment/investment-policy/2506900.pdf.
- OECD (2001), *Corporate Tax Incentives for Foreign Direct Investment*, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264188402-en>.
- Official Gazette of Bosnia and Herzegovina (2015), "Law on custom policy in Bosnia and Herzegovina", 58/2015, Official Gazette of Bosnia and Herzegovina.
- Official Gazette of Bosnia and Herzegovina (2009), "Law on free zones in Bosnia and Herzegovina", 99/2009, Official Gazette of Bosnia and Herzegovina.
- Official Gazette of Bosnia and Herzegovina (2005), "Law on Value Added Tax", 09/2005, Official Gazette of Bosnia and Herzegovina.
- Official Gazette of Bosnia and Herzegovina (2004), "Law on custom policy in Bosnia and Herzegovina", 57/2004, Official Gazette of Bosnia and Herzegovina.
- Official Gazette of the Republic of Serbia (2013), "Decree on changes and amendments of the regulation on state aid provision", 97/2013, Official Gazette of the Republic of Serbia.
- Official Gazette of the Republic of Serbia (2006), "Regulation on more specific criteria for the assessment of the economic viability of the establishment of free zone territories", 69/2006, Official Gazette of the Republic of Serbia.
- Owens, J. (2005), "Competition for FDI and the role of taxation", in *Tax Systems and Tax Reforms in New EU Members*, Routledge, London.
- Port of Bar (undated), "Laws", Port of Bar website, www.lukabar.me/eng/laws.htm.
- Radosevic, S. and A. Rozeik (2005), "Foreign direct investment and restructuring in the automotive industry in Central and East Europe", *Working Paper*, No. 53, Centre for the Study of Economics and Social Change in Europe, UCL, <http://discovery.ucl.ac.uk/17517/1/17517.pdf?ref=klasshop.com>.
- Sanfey, P., J. Milatović and A. Krešić (2016), "How the Western Balkans can catch up", *EBRD Working Papers*, No. 186, European Bank for Reconstruction and Development, London.
- Sturgeon, T.J., and R. Florida (2000), "Globalization and jobs in the automotive industry", *Industrial Performance Centre Working Paper Series*, MIT-IPC-00-012, Massachusetts Institute of Technology, <https://ipc.mit.edu/sites/default/files/documents/00-012.pdf>.
- University of Texas at Austin (2016), "Map collection", University of Texas Libraries website, www.lib.utexas.edu/maps/.
- World Bank (2016), *World Bank Doing Business* (database), World Bank, Washington, DC, <http://data.worldbank.org/data-catalog/doing-business-database>.
- WEF (2016), *World Economic Forum: The Global Competitiveness Report: 2016-2017*, World Economic Forum, Geneva, www3.weforum.org/docs/GCR2016-2017/05FullReport/TheGlobalCompetitivenessReport2016-2017_FINAL.pdf.
- wiiw (2016), *Annual Database 2016*, wiiw Databases website, <http://data.wiiw.ac.at/annual-database.html>.



TRACKING SPECIAL ECONOMIC ZONES IN THE WESTERN BALKANS

OBJECTIVES, FEATURES AND KEY CHALLENGES

Since the economic crisis and the consequent reduction in global financial flows, Western Balkan economies underwent a structural shift from consumption-fuelled to investment-based and export-oriented growth. In their effort to strengthen market-oriented enterprises and promote job creation – two of the major challenges to development in the region – special economic zones (SEZs) are becoming prominent policy tools for Western Balkan economies.

The number of zones has quadrupled over the past eight years as some economies expanded their existing zone networks and others created them for the first time. SEZs and their accompanying incentives have also become relevant drivers in the intensifying regional competition for foreign direct investment, but while their direct contribution to investment and job creation has been positive, their broader impact on the industrial structure of the Western Balkan economies is more limited. Because of considerable gaps in technological and managerial capacity, local enterprises still struggle to build strong supply connections with foreign companies, and their exposure to foreign enterprises is not yielding a significant transfer of know-how and increase in competitiveness.

This report represents an in-depth analysis conducted under the OECD South East Europe regional programme, which supports partner economies in developing and implementing structural reforms, with the aim of boosting growth and fostering competitiveness.

The study takes a closer look at the main features and trends in the development of SEZs in the Western Balkans and raises key questions for further analysis of this important topic.

