

# The Effect of Corporate Profit Tax on Attracting Foreign Direct Investment in Albania

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## Abstract

The aim of this study is to analyze the major cause of the instability of foreign direct investments in Albania these last years, their lowest level of FDI when compared with other countries in the region, and the importance of these investments in developing countries like Albania. The size of FDI has a significant effect on the financial and macroeconomic factors, government and infrastructure factors, and the factors by fiscal nature. In this study, we disengage fiscal factors and in particular, the corporate profit tax rate. The aim of this study was to prove that in countries with weak legal infrastructure, this factor is statistically significant in attracting Foreign Direct Investment. Thus, should Albania be considered as a country with weak legal infrastructure? Due to this question, we took into consideration specific indicators measured in recent years by various world organizations by comparing them with various countries of the region. Also, we built an econometric model through multiple regression by collecting data on the tax rate applied in Albania from 1992- 2016, and the level of FDI for this period. This is in a bid to ascertain the effect or impact that profit taxes has on FDI inflows in Albania. In conclusion, Corporate Tax Rates is a factor that has a very significant impact on the size of FDI in Albania.

**Keywords:** FDI, corporate tax rates, panel data analysis

**JEL:** F21, H25.

## 1. Introduction

The importance of foreign direct investment is always increasing, especially after the development of globalization that has occurred recently in the world. In the last two or three decades, a lot of authentic empirical studies of various researchers have been made. These researchers have proven major benefits as a host country of FDI, but the disadvantages or losses that host countries have, especially in small countries where foreign investors are favored by the respective governments for privatization or concession granting of some state companies versus a lower value than the market, is to have the benefit of the political campaign. Another reason is that economy experts believe that foreign direct investment negatively affect the balance of payments. This makes it unstable as a result of inflows from the beginning and then outflow until the repatriation of capital. However, comparing the cost of foreign direct investment with the benefits host countries have, these researchers confirmed and proved that these are very small. For this reason, developing countries most especially are always in competition with each other to create a more favorable business climate for attracting foreign direct investment.

The passage through transition in Albania is accompanied by liberalization and privatization. Here, an important role is also played by foreign capital. Subsequently, Albania applies a liberal market regime. Foreign trade has been liberalized since 1990 and it follows the standards set by the European Union (EU) and the World Trade Organization. Due to its power, Albania has 37 bilateral agreements on mutual protection and encouragement of investments. Some important agreements in which they adhere to are: Free Trade Agreements, Stabilization and Association Agreement (SAA), Central European Free Trade Agreement (CEFTA), European Free Trade Association (EFTA), Free trade agreement with Turkey, Diagonal Accumulation

### *1.1 Albania and Generalized System of Preferences (GSP) of the United States*

Foreign capital in Albania was obtained through FDI. They are a very important source of capital flows and they foster the development of an economy. FDI are often regarded as the locomotive of the country, since their focus has

been on important sectors of its economy. The foreign direct investment flows in Albania, in recent years, has occupied an average of 9-10% of gross domestic product.

Basically, there are several definitions of FDI which varies based on their measurement and evaluation.

**According to the classic definition of Rugman and Hodgetts (1995)**, FDI is considered as a company of certain country which makes physical investment by building an industrial enterprise or firm for another random country. Thus, they are often considered as political issues in our country.

There are two types of FDI, otherwise known as portfolio investments. They are investments that are carried out through existing financial channels between the investment country and the receiving country, while the other type are the investment that is "directly" carried out in machinery equipment, buildings, and not only during the flows of capital.

FDI in Albania are regulated by law No. 7764, dated 02.11.1993 "Law on Foreign Investment." The law reads: "Foreigners have the right to engage in economic activities without the need of a possible authorization or license. Foreign investors are treated no less favorably than Albanian citizens, except in cases involving the possession of land, a case which is handled by a separate law. Albanian legislation provides that at any time or occasion, foreign investment will be treated equally and fair and will get full protection and security." Also, according to this law, foreign direct investment includes investments of foreign individuals and institutions in the local economy. Consequently, this is used for the purchase of at least 10% of the equity of an enterprise.

Foreign direct investments are an important indicator of the confidence of foreign investors in the country. Basically, they are downgraded in terms of economic and political crises. Also, they grow in terms of improving the economic and political environment. The value of foreign direct investment in our country, measured in USD, has been unstable over the past 24 years as can be seen from Figure 1.

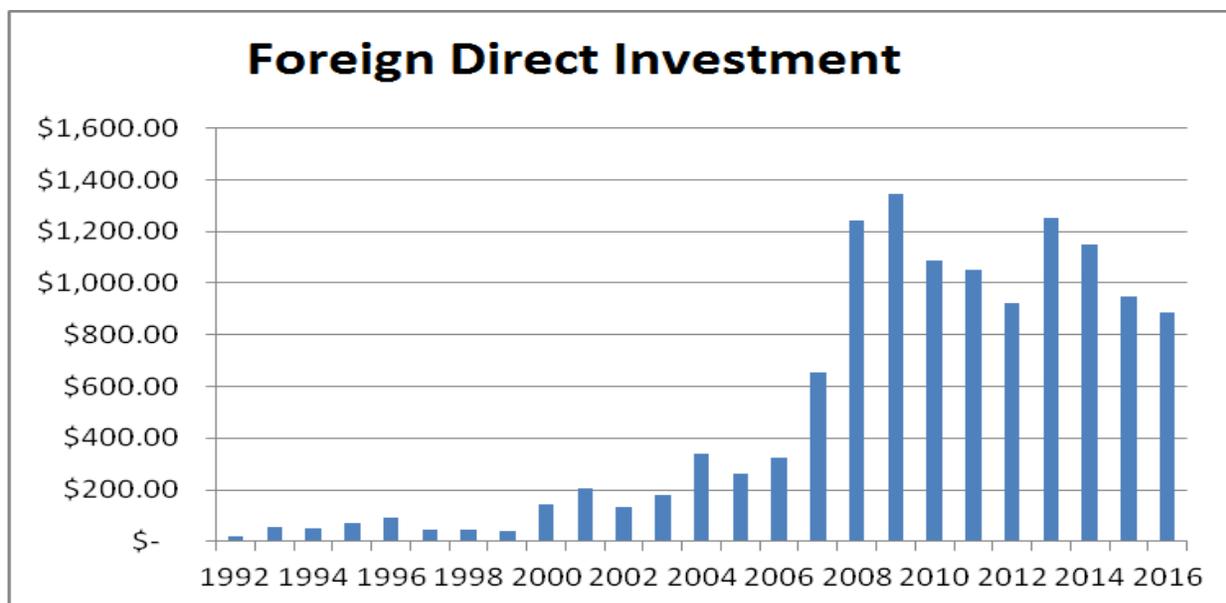


Figure 1. FDI over the years

At the end of 2009 and at the beginning of 2010, the value of foreign direct investment reached 1.11 billion USD. This was the highest value achieved during the analysis period from 1992-2016. In this year, foreign direct investments grew by 249%.

As a result, Albania was ranked second in the region after Serbia, being placed in a more favorable position with neighboring countries due to its tourism and textiles industries above all. A high level of investment is a supporting factor for growth. This increase occurred for two reasons in our view, primarily because:

1. Profit tax rate was lowered from 23% that it was in 2005 to 20% in 2007 and to 10% in 2010.

2. The high degree of privatization made during this period in our country.

Furthermore, the highest decrease is noted during the crisis year of 1997, when foreign direct investment decreased by 47%.



Figure 2. Foreign Direct Investment dynamics in the last 3 years

The behavior of FDI in 2016 has highlighted their unstable structure as can be seen in Figure 2. For several years, there is a lack of inflows of new investors in the country, unlike neighboring states, especially Macedonia and Serbia. This is very good news for the entrance of foreign companies which promises stable economic growth as they are mainly concentrated in automobile industry.

According to the statistics of the balance of payments of the Bank of Albania, FDI recorded a strong decline of 42% in the first quarter of this year compared with the same period last year. Foreign investments were 152 million euro in the first quarter, from 261 million euro in January-March 2015, and 222 million euro in first quarter of 2014.

1. According to the Bank of Albania, inflows in the form of direct investment continue to remain concentrated in the hydrocarbons sector (to the extent of 27 percent), energy (about 25 percent), construction (to the extent of 17 percent), and telecommunications sector (6 percent). Thus, the biggest decline of the flow of FDI is observed in the hydrocarbons sector. In recent years, the biggest investor in the country has been Bankers Petroleum which operates in the hydrocarbons sector. Investments in this sector during the first quarter of this year constituted 40% of total investments.

A decrease of foreign direct investments was expected. According to the official data of this company during the first quarter of 2016, capital expenditures have fallen to \$13 million compared with \$ 25 million at the last quarter, and \$ 50 million in first quarter of 2015.

According to the statistics of the liabilities of system published by The Bank of Albania, the addition of banks capital, another element that encouraged investment in 2015, was 20% lower in the first quarter of 2016 compared with the same period last year. Mobile license, which gave a rise to foreign investment in the first half of 2015, were not given in the first months of this year. Higher taxes in the region, lack of incentives (Serbia e.g. though has taxes that are comparable to us, offers subsidies to investors) exacerbated climate of current investors', which is openly reported from all rooms abroad were some of the reasons that are keeping foreign investors away. Weibo, a major Turkish enterprise, in the textile industry has opened branches in Macedonia and then moved to Serbia. Johnson Control, Lear Corporation, and Capco are three enterprises in the area of the car support industry, which have shown interest in Albania, have now invested in Macedonia.

For now, the only hope are the two major strategic investments, gas pipeline TAP and the HPP of Devoll.

Also during 2016, Albania has adopted a liberal legal framework designed to create a favorable investment climate for foreign investors by adopting a new law on strategic investments in Albania. The law expressly provides as "strategic investments" private investments, public investments, and/or public-private investments in various sectors of the economy. So, through this law, the government intends to increase the FDI through concessions or public private partnership. This they did by not reducing the profit tax rate for foreign investors. FDI in Albania will continue to be an important source of capital flows and economic development.

### *1.2 The Aim and Methodology of the Paper*

The aim of this study is to prove that based on the level of FDI in a country like Albania with weak legal infrastructure, besides the macroeconomic and financial factors, governmental factors, infrastructural factors, and fiscal factors have a great influence on the level of FDI. To fulfill the aim of the study, we have taken the tax rate of profit tax of companies. Also, we are going to see the impact that this fiscal factor has on the level of FDI by raising the following hypothesis:

Hypothesis 1: In countries with weak legal infrastructures, profit tax has a strong negative correlation and impact, with FDI inflows.

The study undertakes to confront and certify the raised hypothesis.

According to the purpose of the study, it made a detailed analysis of FDI in our country based on statistical data. To realize this paper, we used several research methods such as analysis of documentation and comparative analysis which are referred to specific literature for FDI through reading. However, these methods allow us to analyze and compare the progress of the level of FDI in Albania and the tax rate on the profits of companies in the time extension. This is carried out for the period of 24 years in which the study is expanded. It also involves spatial extension by comparing them with the region. The literature used is taken from the official websites of the World Bank. Also, a major role occupied the reports published by the Bank of Albania, Ministry of Finance, INSTAT, Open Data Albania, UNCTAD etc.

Subsequently, the data collected for the study are secondary data for which we do not have evidences for their reliability because they are provided by official site. Although the data are official, our model has restrictions due to the quantitative analysis. In addition, the series of 24 Observations is just too small and can affect the drawing of conclusions. Since the rate of errors in the results of the quantitative analysis is the order of the thousandth, they are considered as acceptable errors which cannot affect the outcome of the analysis. For this reason, the model results should be seen more qualitatively rather than quantitatively. We believe that these results, which are similar but not very accurate, highlight the strong negative correlation between FDI and Corporate Tax Rates. Through computer programs such as QuickBooks and financial programs such as Alpha or Excel, and the statistical program SPSS, data analysis was carried out using the method of simple statistical regression. Through this method, it was possible to clarify the probabilistic and structural impact of the Tax Rates indicator of Corporate (as independent variable) on the level of FDI (as dependent variable). To see how parametric changes will affect FDI flows, we used an econometric model that is presented in Chapter 2.

## **2. Factors That Affects FDI and Legal Infrastructure in Albania**

Basically, there are a group of factors that affect FDI inflow: Macroeconomic and Financial factors, Government and Infrastructure factors, and fiscal nature factors.

**Macroeconomic and Financial Factors:** They are economic openness degree to foreign trade, trade exchanges and technology transfer, the industrial privatization degree, labor cost and employment level in the host country, interest rates for financing, exchange rate, and inflation rate.

**Government and Infrastructure Factors:** This group includes political risk factor which is measured by other measurable variables such as: political stability, corruption level, implementation of laws, bureaucracies in the public administration, etc. which are statistically significant to incoming flows of FDI (Busse & Hefeker, 2005). The infrastructure development level such as road system, railways, ports, and airports are also important (Jordaan, 2004). Others include Geo-social factors, etc.

**Factors of a Fiscal Nature:** This factor include profit tax, tax on income from the company dividends, fiscal burden, the number of tax payments, and the time (in hours) that it takes for a business to finish the fiscal obligations. However, according to empirical studies made by Hotaman (1994) and Hines, Rice, and Cassou (1997), they are statistically significant to incoming flows of FDI.

The study is focused on measuring the degree of the influence of fiscal factors, specifically the profit tax of investment companies to the size of FDI inflows for the entire post-communist period. Before we prove this impact, we have to prove the reason Albania is considered to be a country with a weak legal infrastructure. Also, we have to support or agree with the conclusions reached by Christian Bellak, Markus Leibrecht, and Jože P. Damijan (2009) at The United Nations Conference on Trade and Development (UNCTAD, 2012). However, they have confirmed that countries that have a strong legal infrastructure may have the opportunity to apply high tariffs for profit tax. Also, they do not adversely affect the inflows of FDI and the use these corporate taxes to finance the infrastructure. Therefore, they were able to prove that countries with weak or inferior legal infrastructure should apply a lower corporate tax rate to attract FDI within a short period of time. So, there is a negative correlation of profit tax degree with the inflows of FDI.

To determine whether or not Albania is considered a country with weak legal infrastructure, we will refer to some specific indicators of 2015 which would help to determine it. Thus, they are measured and published by various international organizations. Some of these indicators are:

1. **Economic globalization factors** with impact on FDI for 2015: KOF is the lowest for the Western Balkans, social globalization with the value 42.56, and political globalization with the value 55.75. This indicator is related with technology and communication, the migration of citizens, capital flows, and technology transfer.
2. **The legal system:** The legal system is subject to frequent changes and not being applied strictly brings risk for foreign investors.
3. **Facility of doing business** is another indicator that foreign investors refer to, before taking decisions for investment in the host country. For this indicator, Albania is ranked 68th in a list with the participation of 189 countries for year 2014-2015. However, Albania is in a very low position compared to Macedonia which ranked 30th and Montenegro which ranked 36th.
4. **Economic stability (inflation).** This is a complex indicator that is measured by the changes of inflation in the economy. In recent years, it ranges from 0-4% and its trend shows stability compared with other countries in the region.
5. **Professional and training human capital level.** This indicator measures the implementation of new technologies in developing countries. According to the UNDP's annual report for 2015 from 188 different countries of the world, the index of human capital development ranks Albania as the country with the lowest level in the Western Balkans. Thus, Albania was ranked at the 85th place together with Bosnia and Herzegovina.
6. **Labor cost.** It is not the lowest in the region which is 388 Euro / month, while Serbia is 367 Euro / month.
7. **The fiscal burden as a percentage of the profit of commercial companies.** Albania and Serbia are the countries with the highest fiscal burden in the Western Balkans in the last years. Otherwise, Kosovo and Macedonia have a lower fiscal burden which makes them more competitive on the withdrawal of FDI. For Albania in 2015, it was 37% and it increased to 40% in 2016.
8. **Cost of financing with loan** in Albania is very high compared with other countries in the region and the world. It is 8.7% for Albania, while in countries like Greece, Italy, Turkey, Cyprus, Switzerland, and the USA, this cost is 3.5% for foreign investors.
9. **Physical infrastructure.** This indicator determines how km motorways are for every 100 inhabitants by comparing this with various countries of the region. As a result, we can say that Albania has road infrastructures in very low parameters compared to countries in the region.
10. **Corruption Perception Index:** This is the most important indicator that directly affects the absorption of FDI, and provides business climate entirely in the host country.

According to the publication of the annual report made by the World Bank with the "Transparency International" organization for 2015, by 178 countries ranks, Albania was seen as the country with the highest corruption in the public sector of the Western Balkans, leaving behind only Kosovo.

Referring to the above indicators, we conclude that Albania is a country with weak legal and road infrastructure. Thus, this makes the correlation of profit tax degree with the inflows of FDI stronger.

### 3. Analysis and Regression

#### Hypothesis 1: In countries with weak legal infrastructures, profit tax has a strong negative correlation and impact with FDI inflows.

To analyze and to prove the above hypothesis and the connection between the corporate profit tax rate and the level of FDI inflows, we made an econometric model through the regression model. In this connection, we considered the profit tax rate as an independent variable, while the level of FDI inflows as a dependent variable.

Based on the data obtained from the below Table 4, which shows the profit tax rate applied in Albania from 1992 to 2016 as well as the level of FDI inflows for this 24 years period, we have found the link between these two variables which is expressed through the appropriate equation:

The regression equation is:

$$y = - 5669.6 \times + 1722.2$$

$$FDI = 1722.2 - 5669.6CIT$$

So y – Dependent variable, so FDI

× – Independent variable, so Corporate Profit Tax

#### OUTPUT

Table 1. Regression statistics

<i>Regression Statistics</i>		
Multiple R	0.97	Perfect correlation
R Square	0.93	
Adjusted R Square	0.93	
Standard Error	129.48	Standard deviation
Observations	25.00	

$S = 129.48, R^2 = 97\%$

$R_{adj} = 93\%$

Table 2. ANOVA

	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1.00	5,227,503.08	5,227,503.08	311.80	<b>0.00</b>
Residual	23.00	385,601.91	16,765.30		
Total	24.00	5,613,104.99			

Source: Author's calculations

Table 3. Analysis of variance (Source: Author's calculations)

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>
Intercept	1,722.18	73.79	23.34	<b>0.00</b>	1,569.53	1,874.83	1,569.53
CIT	(5,669.63)	321.08	(17.66)	<b>0.00</b>	(6,333.84)	(5,005.43)	(6,333.84)

The equation is of first degree indicating that the connection is linear. The value before × is negative, which shows the negative correlation that exists between the two variables. Also, the coefficient of determination  $R^2 = 0.9313$  shows a very good approximation of variables taken in the analysis. Sipas të dhënave të regresionit më sipër, mund të themi se CIT është shumë i rëndësishëm në përcaktimin e IHD-ve, duket shumë e qartë dhe vlera e  $p = 0.00$ , pra

$\text{është} < 00:05$ . As expressed in the Figure 3, we can say that CIT has a strong negative correlation with FDI. Therefore, the higher the tax rate on profits in countries with weak legal and road infrastructure like Albania, the lower will be the inflows of FDI.

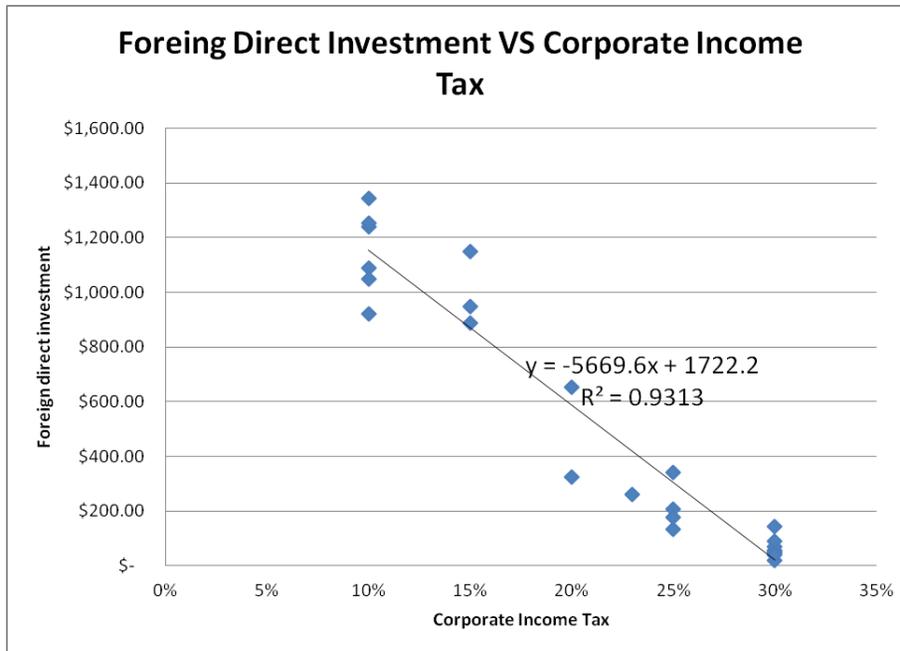


Figure 3. Foreign direct investment depending on the profit tax rate

Thus, we confirmed the above hypothesis that: **In countries with weak legal infrastructures, the profit tax has a strong negative correlation and impact on FDI inflows.**

Table 4. Data on the relation between Foreign Direct Investment and Profit Tax

	\$ 1,000,000.00	
Year	CIT	FID
<b>1992</b>	30%	\$ 20.00
<b>1993</b>	30%	\$ 58.00
<b>1994</b>	30%	\$ 53.00
<b>1995</b>	30%	\$ 70.00
<b>1996</b>	30%	\$ 90.10
<b>1997</b>	30%	\$ 47.50
<b>1998</b>	30%	\$ 45.01
<b>1999</b>	30%	\$ 41.20
<b>2000</b>	30%	\$ 143.00
<b>2001</b>	25%	\$ 207.30
<b>2002</b>	25%	\$ 135.00
<b>2003</b>	25%	\$ 178.04
<b>2004</b>	25%	\$ 341.29

2005	23%	\$	262.48
2006	20%	\$	325.14
2007	20%	\$	652.28
2008	10%	\$	1,240.97
2009	10%	\$	1,343.09
2010	10%	\$	1,089.42
2011	10%	\$	1,049.43
2012	10%	\$	920.08
2013	10%	\$	1,253.78
2014	15%	\$	1,149.38
2015	15%	\$	948.30
2016	15%	\$	888.10

Source: UNCTAD, *WIR11* and Global Investment Trends Monitor No.8 and Bank of Albania. \*UNCTAD estimate

#### 4. Conclusions

1. Foreign direct investments are an important indicator of the confidence of foreign investors in the country. They are downgraded in terms of economic and political crises, and they grow in terms of improving the economic and political environment.
2. For several years, there is a lack of inflows of new investors in the country, unlike neighboring states, especially Macedonia and Serbia.
3. In recent years, the biggest investor in the country has been Bankers Petroleum
4. Albania for 2015-2016 has applied the higher taxes in the region. There are lack of incentives (Serbia e.g. though has taxes that are comparable to us, offers subsidies to investors) that exacerbated the climate of current investors'.
5. In 2016, Albania has adopted a new law on "strategic investments" private investments, public investments, and/or public-private investments in various sectors of the economy.
6. Referring to specific indicators in micro and macro level published by international organizations for 2015-2016, we conclude that Albania is a country with weak legal and road infrastructure.
7. Through regression analysis, we confirmed that in countries with weak legal infrastructures, like Albania, the profit tax has a strong negative correlation and impact with FDI inflows.

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