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DOI: 10.46793/LawPG.595LS

INCENTIVES TO ATTRACT FOREIGN DIRECT INVESTMENT

Abstract

The aim of this paper is to present and analyze different types of incentives that countries use to attract foreign direct investments. The aim of attracting foreign direct investments is to achieve a higher level of economic development and social welfare. Investment incentives are used by developing countries as well as developed ones. There are various types of incentives such as fiscal, financial and regulatory incentives. The author attempts to determine the justification for the use of incentives, but also attempts to state the reasons why their use is not justifiable. The paper also points out the situation in which investments are profitable only until the incentives last, meaning that incentives themselves can be very expensive and inefficient for the host country. Approval for incentives to attract FDI is usually motivated by the desire to achieve spillover effects in the countries receiving the investment, such as transfer of new technologies, know-how, increase of competitiveness, etc. Those investments that are expected to have the strongest spillover effects are therefore the ones that need to be attracted.

The rules of the law of the Republic of Serbia which regulate a variety of incentives to attract investments are also the subject of this analysis.

The methodological approach for this research includes using different methods such as the comparative method, the normative-dogmatic method as well as the analytic-synthetic approach.

Key words: *incentives, foreign direct investments, grants.*

1. INTRODUCTION

Foreign direct investment¹ is of particular value to the national economy, especially the economies of developing countries that do not have enough of

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¹ There is a presumption in literature that foreign capital, on average, has a positive effect on domestic investments, but not on the national savings. However, regardless of the increasing integration of financial markets and based on the assumptions about the low mobility of capital between member countries of the OECD, the conclusion is that there is

their own capital to finance economic development. A built institutional system, a real exchange rate, low inflation, legal security, or in other words, a stable legal system that protects property and encourages savings and investments are particularly important for foreign direct investments.

There are three forms of foreign capital inflow into the country. These are foreign direct investments (FDI)², portfolio investments and other foreign investments (such as foreign loans).³ FDIs occur as a result of expectations of higher profits from abroad, thanks to cheaper manufacturing factors, often with the help of various benefits and incentives by the host country. Through FDI, the investor acquires a lasting interest by acquiring 10% or more stake in a foreign company.⁴ Portfolio investments represent the kind of foreign investments that provide the investor with return on equity (actually generate income through the purchase of securities), but not with control over the company's operations abroad. Thus, the investor here has no influence on the use of his invested capital in securities.⁵ Unlike FDI, portfolio investments enable the investor to acquire less than 10% of the ownership. Other investments usually include different types of loans. These may be state loans, bank loans, international financial organizations loans, etc.

The size of the market, income, possession of natural resources, skilled work force, infrastructure and things that enable specialization of production, as well as the macroeconomic stability in the host country are the things that

a close connection between domestic savings and domestic investments. This is the so-called Feldstein - Horioka puzzle (1980). This is one of the major "mysteries" of the international economy. However, the truth is that in the years that followed the setting up of this conclusion, the mobility of capital between countries increased, whereas the correlation between savings and investments decreased, or became very low in last twenty years (D. Giannone, M. Lenza, *The Feldstein-Horioka fact*, ECB, Working Paper Series, No. 873, 2008, 7, 19).

² FDI as a form of foreign capital had the largest inflow in transition countries in the period between 1993 and 2000. Then followed the loans, and portfolio investments (Ž. Lovrinčević, Z. Marić, D. Mikulić, *Priljev inozemnog kapitala – uticaj na nacionalnu štednju, domaće investicije i bilancu plaćanja tranzicijskih zemalja srednje i istočne Evrope*, *Ekonomski pregled*, 56 (3-4), 2005, 168). It is interesting to indicate the fact that in 2013 FDI had a value of 1.300 billion dollars, while the budget of the EU for a six-year period (2014-2020) was projected to 960 billion euros (R. Vukadinović, *Pojam i pravno regulisanje stranih investicija*, *Pravo i privreda*, 7-9/2016, 148).

³ Foreign direct investments and portfolio investments belong to the category of private capital and loans are in the category of public capital (S. Kovačević, *Međunarodni ekonomski odnosi*, Kragujevac, 2000, 302-303).

⁴ Ž. Lovrinčević, Z. Marić, D. Mikulić, *op.cit.*, 167.

⁵ S. Kovačević, *op.cit.*, 303-304.

motivate companies to invest their capital.⁶ We can, therefore, say that the market itself attracts investments and its characteristics make it a magnet for attracting them.⁷ If the aforementioned fundamental conditions existed, then the investment incentives would not be of great importance. Globalization, i.e. liberalization, contributes to easier movement of the market.⁸ This is why investment incentives are becoming more and more important as the new way of competition with the aim of increasing the production, employment and so on.⁹ Competition is particularly present between those countries or regions that are already attractive enough for investors due to their favorable location. In that sense, countries can improve their laws, which can lead to the abolition of barriers to foreign capital entry (liberalization).¹⁰ Competition between countries can lead to a real "bidding war" which often results in very high (expensive) subsidies¹¹ for the country, and on the other hand,

⁶ M. Blomström, A. Kokko, *The Economics of Foreign Direct Investment Incentives*, Stockholm, 2003, 4.

⁷ Investments should be directed to the real sector of economy and to the service sector. UNCTAD's document from 1999 states that FDI in the service sector contribute to the employment growth and growth in exports, and also contribute to the highly specialized services. However, we should critically view the fact that FDI is dominant in the service sector since it may create problems for the host country. This trend was typical for Serbia, in the period between 2000 and 2008, where most foreign investments were concentrated in the following sectors: banking, insurance, telecommunications, real estate and retail trade. The problem with this kind of dominant investment structure is reflected in the fact that it can cause a number of negative consequences, especially if the economic activity is not accompanied by large inflows of foreign currencies (B. Begović *et al.*, *Grinfield strane direktne investicije u Srbiji*, Beograd, 2008, 27). If there is a high import demand, this inevitably leads to the deepening of the balance of payments deficit. It is also interesting that customers can benefit from cheaper imports due to FDI, and on the other hand, it can cause the loss of jobs in certain sectors, although UNCTAD's report contains a statement that this would be offset by employment growth in other sectors of the economy of the host country: UNCTAD, *Foreign Direct Investment and Development*, New York, Geneva, 1999, 45-46).

⁸ At the same time these are the processes that promote integration, especially financial integration. More information on that: J. Labudović Stanković, *Finansijska tržišta Evrope – pregled i analiza*, Kragujevac, 2012, 14-22.

⁹ M. Blomström, A. Kokko, *op.cit.*, 6.

¹⁰ The abolition of barriers has led to intense movement of capital and greater integration of financial markets (J. Labudović Stanković, *Potreba i razlozi regulisanja finansijskog sektora*, u: XXI vek – vek usluga i Uslužnog prava (ur. M. Mićović), Kragujevac, 2013, 5).

¹¹ It is interesting to note that it is very difficult to determine which is the right size of subsidies received by foreign investors.

causes a drastic reduction of labor standards, environmental protection and so on. The funds for government investments are usually provided by loans, particularly from abroad. Therefore, this is the use of foreign accumulation. There are examples, albeit very rare, in which investment funds are provided from domestic resources,¹² i.e. from domestic savings. Such an example can be found in Japan and a number of other Asian countries in which there is a high growth rate of savings.¹³

2. JUSTIFICATION FOR THE USE OF INCENTIVES

When a country approves incentives for attracting investments it always raises the question of the eligible costs of those incentives and whether the incentives can provide a return that is at least equal to the spendings that the incentives require. In other words, can the earnings compensate for the expenses that the country had due to the granted incentives.¹⁴ The earnings of the investments should also provide the profit that the investors could have earned if he had invested funds in other businesses. The question of the justification for the use of incentives is always related to the effects of the investments in the host countries, and a certain amount of time is always needed for that.

It is believed that investment incentives are justified in a situation when conditions for doing business and approaching the market are different, depending on whether it is a foreign or a domestic company.¹⁵ Danger for the host country arises in a situation in which the subsidies or incentives are so large that they “eat up” the expected gain for the host country. This way, all the benefits belong to the foreign investor and domestic companies are being discriminated against, while the host country is left without the

¹² In this context, we can mention Norway as a very specific country (it has a very open economy with a very powerful and developed public sector). It is a symbol of a healthy and strong economy and is the epitome of high living standards. As one of the world's largest oil exporters, it has huge capital, and it formed the National Petroleum Fund from oil revenues and now invests funds in accordance with the ethical policies of the Norwegian Government (J., Labudović Stanković, *Finansijsko tržište Norveške*, u: XXI vek – vek usluga i Uslužnog prava (ur. M. Mićović), Kragujevac, 2014, 104, 108).

¹³ A country used domestic savings for building infrastructure is for example Singapore (R. Vietor, *Kako se zemlje natječu – strategija, struktura i državno upravljanje u globalnoj ekonomiji*, Zagreb, 2010, 33).

¹⁴ M. Blomström, A. Kokko, *op.cit.*, 7.

¹⁵ For example Ireland and Singapore have based their development on the investment incentives policy.

expected public revenues.¹⁶ Incentives for attracting investments can contribute to disruption of healthy competition and lead to the loss of local companies due to the more favorable position of foreign investors. The public often talks about insufficient protection of foreign investors, while practice shows cases of foreign investors being “over-protected”.¹⁷ We believe it is unjustifiable to grant incentives that are only politically motivated and are not economically justified. It is also noteworthy that developing countries, due to their weak negotiating position, tend to offer various kinds of incentives in order to attract foreign investments.¹⁸ Their reasons for using incentives lie in the fact that the investments are their only way to solve the problems of unemployment, debt settlement, economic growth, etc.

The literature states that the justification for investment incentives is a situation when a foreign company differs from a domestic company in terms of economic activity, the manufacturing process and the possession of specific or intangible assets - (such as knowledge, new technology, managerial skills)¹⁹ that can be passed on to local companies. In addition to raising revenue, the external effects of FDI, i.e. spillovers, are very important for the host country. However, spillover as a positive externality of investments does not occur immediately and often depends on local companies. Namely, it is important that domestic companies want to invest in new technology and learn from foreign companies.²⁰

Spillover effects can be seen through: entry into branches that are characterized by high entry barriers, abolition of monopolies, transfer of technology, increase of competitiveness, eliminating the so-called bottlenecks, introduction of know-how, higher productivity of domestic companies, new types of economic activity, better management, and the like.²¹ Spillover effects are divided into the inter-branch and the intra-branch (horizontal) effects.²² There are numerous data on the positive spillover effects but research shows that negative spillover effects have also been

¹⁶ M. Blomström, A. Kokko, *op.cit.*, 17.

¹⁷ V. Draškoci, *op.cit.*, 412.

¹⁸ V. FitzGerald, *Regulatory Investment Incentives*, OECD, 2001, 2.

¹⁹ C. Sanda, L. Dana, *Foreign direct investment incentives*, Revista Tinerilor Economisti, 7/2007, 150.

²⁰ M. Blomström, A. Kokko, *op.cit.*, 19.

²¹ China is a true example of a country in which the FDI led to transfer of technology, know-how, improvement of managerial skills (R. Vietor, *op.cit.*, 13).

²² B. Begović *et al.*, *op.cit.*, 58-59.

identified.²³ It is believed that the spillover often depends on the characteristics of the host country. Spillover effects will be more pronounced in countries with higher levels of education of the labor force, greater competition, etc. Some conclusions state that not all the industrial branches can count on spillover effects.

The important rule in granting investment incentives is that incentives must be equally available to both domestic and foreign investors, i.e. without discrimination against local companies.²⁴ It is important to note that they should primarily be granted to companies or sectors that are expected to have the greatest spillover effects. Along with the approval of incentives, the country needs to build infrastructure (for example, industrial parks), educate the labor force, improve the business climate.

It is often written in literature that, macroeconomic and political stability of a country, a large market, skilled labor force, free entrance to the market, infrastructure, developed banking (financial) sector and quality of telecommunications are of great importance for foreign investors with long-term investments, while fiscal and financial incentives are not so important.²⁵ Of course, if the location of a country is attractive, the country will not have to worry about incentives. However, if that is not the case, than the country will have to base the attraction of foreign investors on incentives and privileges. The host country can allocate privileges based on the bilateral agreement on investments by which it often waives a part of their sovereignty.²⁶

²³ Limitations arising from FDI inflow can be of both economic and non-economic nature. Thus, for example, it can lead to deterioration of the balance of payments, bad influence in the environment, etc. (*Foreign Direct Investment for development: Overview*, Paris, 2002, 6). In addition, there can be a very small effect on the growth of productivity of local companies, the absence of a significant transfer of high technology, etc. (M. Blomström, A. Kokko, *op.cit.*, 13).

²⁴ Yet, incentives to domestic investors are not always the example of efficient government policy. Such was the case in Italy. Italy approved incentives to domestic companies in the industry sector, based on Law 488, in order to invest in the lagging regions, particularly in the regions in the south of Italy. The funds were granted according to the previously defined criteria (number of jobs, the percentage of capital invested, the amount of assistance required). However, the results were not quite as they had expected (R. Bronzini, G. de Blasio, *Evaluating the impact of investment incentives: The case of Italy's Law 488/1992*, *Journal of Urban Economics*, No. 60, 2006, 346).

²⁵ C. Oman, *Policy Competition for Foreign Direct Investment - A study of Competition among Governments to attract FDI*, Paris, 2000, 17.

²⁶ Đ. Popov, *Procesi u svetskoj privredi i Srbija*, Novi Sad, 2011, 34.

3. CONCEPT AND TYPES OF INCENTIVES

Although generally accepted definitions do not exist, we can say that investment incentives are instruments for stimulating investment activity in a country, and can refer to attracting both FDI²⁷ and domestic investments. However, special attention is often given to attracting foreign investments.²⁸ A broader definition would say that any kind of help provided to the investors by a certain country could be considered an investment incentive. On the other hand, a narrower definition would refer to providing specific assistance²⁹ to investors. The main feature of incentives is that they are limited in time. The investor should make his investment profitable as much as he can while the incentives last. However, this fact opens up a new problem. It is possible that the investment is profitable only because of the subsidy³⁰ and that the foreign investor will leave the country as soon as the incentives are exhausted. These are therefore incentives for short-term investments and they are just a waste of public funds.³¹

The Agreement on Subsidies and Countervailing Measures of the World Trade Organisation, among all the other international multilateral investment contracts, contains a definition of investment incentives. This agreement

²⁷ The principle of nondiscrimination is directly connected to attracting foreign investments. It is manifested through the national treatment principle and the most favored nation principle. These principles are supposed to guarantee equal (non-discriminating) treatment to all the investors. In the sense of attracting FDI, the national treatment principle implies that contracting parties treat foreign investors the same as the domestic ones. On the other hand, the most favored nation principle implies that contracting parties recognize the foreign investors all the laws and privileges that are recognized in any other country. Practically, this is some sort of a guarantee that contracting parties will treat foreign investments equally, without discrimination. However, it should be pointed out that the most favored nation principle is not only applied within the liberal conception of international economic relations and it is not only used for assigning privileges to countries (investment incentives in our case), but it is also used for introducing many protectionist measures to countries, i.e. investors. These protectionist measure are also imposed upon all the other countries (S. Kovačević, *op.cit.*, 182).

²⁸ This is why in some definitions incentives are only related to foreign investments, not to domestic investments (A. Charlton, *Incentive bidding for mobile investment: economic consequences and potential responses*, 2003, 9).

²⁹ UNCTAD, *Incentives*, UNCTAD Series on Issues in International Investment Agreements, New York, Geneva, 2004, 11.

³⁰ For more information: Dž. Stiglic, *Protivročnosti globalizacije*, Beograd, 2002, 84-85.

³¹ Đ. Popov, *op. cit.*, 42.

recognizes the concept of subsidy³² and identifies it with the concept of incentive. Talking about subsidies in terms of this agreement is possible only if two conditions are met. The first condition is that there is a cash benefit given by the government or other public body, or any income or price difference in terms of Article XVI of this agreement. The second condition is that the benefits³³ are assigned. Accordingly, those would be direct budget transfers, subsidized loans, tax incentives, the purchase of goods by the state, and the like.

Generally speaking, there are two types of incentives; those that aim to reduce risk and uncertainty,³⁴ and incentives that aim to encourage investors to direct their investments towards activities that are of interest for the host country.³⁵

Literature accepts incentives being classified into financial, fiscal and other incentives. Financial investment incentives are, in fact, funds, subsidies and grants for covering production costs and marketing related to investment activities and can also be used for covering part of the capital.³⁶ These incentives include subsidized loans and guaranteed loans as well as state insurance at lower premium rates. This type of insurance usually covers the risk of exchange rate fluctuations, the risk of the national currency devaluation as well as the non-commercial risks (political risks, expropriation).³⁷ Financial incentives are also the subsidizing of salaries, funds for training of the workers, donations of land, funds that the Government sets aside for the construction of railways, roads, industrial parks, often in concert with local authorities.³⁸

³² This agreement dates from the Uruguay Round, and the definition of the term subsidy is established in the first part of it. Subsidies are divided into three categories: prohibited; actionable, which can be subject to disputes, and non-actionable. Subsidies in this agreement refer only to the trade in goods. Besides the WTO agreement which establishes different categories of subsidies, there are also rules in the EU that define which subsidies are prohibited. They take the matter one step further. Namely, the prohibited subsidies are those that limit exports and imports of goods (international trade) as well as those subsidies that have adverse effects on the competition and international trade between the EU Member countries (UNCTAD, *op. cit.*, 34-35).

³³ *Ibid.*, 12.

³⁴ A. Charlton, *op.cit.*, 10.

³⁵ Đ. Popov, *Podsticaji i kontrola inostranih investicija*, Zbornik radova Pravnog fakulteta u Novom Sadu, 3/2008, 44.

³⁶ UNCTAD, *Incentives, op.cit.*, 6.

³⁷ *Ibid.* 6.

³⁸ C. Oman, *op.cit.*, 20-21.

There is a very wide range of different mechanisms that serve to attract and encourage investment in the group of fiscal incentives. Those would be the following incentives: tax holidays,³⁹ lower tax rates, transmission of losses; accelerated depreciation allowances; incentives for investment; reduced social security contributions; non-payment of customs duties on imports of capital goods, equipment, raw materials; non-payment of taxes on products which are subject to export; tax credits; incentives for the export sector of the economy; tax cuts for foreign nationals, etc.⁴⁰

The category of other incentives includes those of regulatory character. Apart from regulatory incentives this category includes various market privileges, the subsidizing of services and the like. Regulatory incentives are, actually, those incentives that are offered to investors by a certain country and are neither classified as fiscal nor as financial incentives.⁴¹ Thus, they are related to deregulation,⁴² the mitigation of environmental standards,⁴³ reduced protection of labor force, the guarantee that the existing legislation will not change to the detriment of investors and the like. There are very important incentives in this category relating to the use of infrastructure (for example, investors can use energy, water, telecommunications, transport infrastructure, etc. under favorable conditions, at lower prices); giving assistance in finding funding sources, management of investment projects; market analysis prior to the implementation of the investment project; advice in the production process; technical assistance; training the labor force to use

³⁹ Tax incentives are in many countries seen as one of the most important determinants of the choice of investment location. It should be noted that the sensitivity of companies, as potential investors, is higher in case of larger cash flows (J. Edgerton, *Investment incentives and corporate tax asymmetries*, Journal of Public Economics, No. 94, 2010, 949).

⁴⁰ C. Oman, *op.cit.*, 20.

⁴¹ V. FitzGerald, *op.cit.*, 2.

⁴² Thanks to deregulation and other incentives, values of FDI have grown sharply since the 1980's. For example, their annual value was 20 billion dollars at the time. In the period between 1994 and 1995, the annual value was 93 billion dollars and in 1997 it reached 149 billion dollars. From that moment on, investments in Asian countries (especially in China, followed by India, Indonesia, Pakistan, South Korea, etc.) and the Latin America countries (Argentina, Mexico, Brasil, Peru, Chile, Colombia, etc.) started to increase rapidly. Among the African countries, attention was given to Egypt, Morocco and Nigeria (UNCTAD, *Foreign Direct Investment and Development*, New York, Geneva, 1999, 11, 14).

⁴³ Environmental issues and liability for damage caused to the environment is extremely important, since environmental pollution is a constant companion of modern economic development. This problem is of international proportions (J. Labudović Stanković, *Osiguranje od odgovornosti za štete prouzrokovane životnoj sredini*, Teme, 3/2012, 1262).

new technologies; improving quality control, etc. The category of other investment incentives also includes: the conclusion of preferential agreements, closing the market for entry of new competitors or giving a monopolistic position to a certain business entity; elimination of exchange risks on foreign loans and so on.⁴⁴

The host country often resorts to lowering labor standards,⁴⁵ and standards related to health care and environmental protection⁴⁶ in order to make the investors lower the costs. The host country can create its regulations in line with the needs of foreign investors. However, such practice can lead to social dumping in order to make the country as competitive as possible. It is important to emphasize that regulatory standards are very important. Their influence depends on the type of company (the investor) and the economy sector that is being invested in, i.e. it depends on the sector the production process will be taking place in. For example, it is very important to some investors for the investment to have good protection of intellectual property. Some investors consider it to be very important for the host country to have protection of corporate ownership and property rights in general, as well as the ability to access the market.⁴⁷ If countries compete in attracting FDI in terms of better protection of property rights and market access, such competition is beneficial because it raises the standards. Yet, the competition that goes towards lowering labor standards and standards related to environmental protection, has no justification because it leads to disturbance of social welfare.⁴⁸

Incentives to attract FDI can be distinguished depending on whether they are provided by developed countries or developing countries. Developing countries usually provide for fiscal incentives, particularly tax relief (exemptions from income tax), low tax rates, accelerated depreciation, return

⁴⁴ UNCTAD, *Incentives*, 7.

⁴⁵ For example, China is well-known for its low labor standards in the sector of textile industry, i.e. readymade garment industry being the labor-intensive industry (V. FitzGerald, *op.cit.*, 7-8).

⁴⁶ When prescribing standards for the protection of the environment the state must be cautious, in the sense that it must not discriminate domestic companies on account of the foreign companies in case of introducing severe environmental protection standards to domestic companies. This means that domestic companies would become less competitive compared to foreign companies (J. Labudović Stanković, *Osiguranje od odgovornosti za štete prouzrokovane životnoj sredini*, 1267).

⁴⁷ V. FitzGerald, *op.cit.*, 4.

⁴⁸ *Ibid.* 10.

of paid customs duties, exemption from customs clearance, etc.⁴⁹ On the other hand, developed countries prefer financial incentives and subsidies, which often cover up to 50% of costs on investments.⁵⁰ They also grant interest-free loans or subsidized loans (at lower interest rates than on the market).⁵¹ These countries, as a rule, grant incentives for attracting investments in under-developed regions⁵² and aside from this their investment incentives policy can also be selective.⁵³

On the one hand, incentives are allocated to attract investments that are necessary for the growth and development of the host country and on the other hand to compensate for some shortcomings of the business environment. Incentives may influence the allocation of financial resources towards those sectors into which incentives are being introduced because it is believed that the resources will be used more efficiently⁵⁴ there. However, there are opinions that incentives are nothing but a waste of resources and that they are not an important factor in attracting FDI.

In some cases, the literature states that externalities from previous investments, shown through the reduction of production costs and facilitating of specialization, may be used as incentives for attracting future investments. It is also stated that market imperfections can be considered as a form of an incentive, such as the labor market in which the unemployed have a much better chance of getting a job with the arrival of investors.⁵⁵ The downside of such incentives lies in the fact that it is very difficult to determine the expected future returns. In other words, it is hard to calculate the expected growth rate, as in employment growth and the increase in tax revenues due to the arrival of foreign investors.

When it comes to incentives, a question that often arises is whom they should be granted to. Should they be granted to all the investors or should a

⁴⁹ UNCTAD, *Incentives*, 5.

⁵⁰ Besides granting subsidies, it is extremely important to ensure the control of expenditure as well (J. Labudović, *Makroekonomska politika Evropske unije*, u: *Pravni sistem Srbije i standardi Evropske unije i Saveta Evrope*, (ur. S. Bejatović), Kragujevac, 2008, 408).

⁵¹ UNCTAD, *Incentives*, 5.

⁵² One of the typical problems of underdeveloped regions is typical of the EU as well. Large assets are allocated for the purpose of financial aid. These assets are often inappropriately spent and are often misused by some interest groups, such as the politicians. This is why the incentive system can sometimes be inappropriate (J. Labudović, *op.cit.*, 407).

⁵³ Đ. Popov, *Procesi u svetskoj privredi i Srbija*, 41.

⁵⁴ UNCTAD, *Incentives*, 2.

⁵⁵ M. Blomström, A. Kokko, *op.cit.*, 7.

choice be made depending on the origin, and the sector in which operations are performed? Incentives should be approved in a way to avoid any kind of discrimination. Yet, distinctions can be made depending on the economy sector which is the carrier of economic development and is expected to contribute to the growth of exports.

4. INCENTIVES IN THE REPUBLIC OF SERBIA

The Republic of Serbia also needs investments in order to increase production and employment.⁵⁶ The investments in question are usually FDI. However, these investments must be profitable in order to bring social benefits to the Republic of Serbia as the host country.⁵⁷ It is not permitted that only investors benefit from the investments. On the other hand, sustainable economic growth and development cannot be achieved only by foreign investments. Investments from domestic resources⁵⁸ must also be included. The advantage of foreign investments is reflected in various aspects: new products in the domestic market, new types of economic activity, new technologies, new knowledge, capital, better quality of product, etc.⁵⁹

Collecting taxes from foreign investors is not sufficient. Overall social benefit is also very important. For example, instead of selling agricultural land to foreigners, Serbia should let the local people own agricultural land and encourage development of cooperatives.⁶⁰ In that sense, our experts have proposed negotiations on the postponing of the application of Article 63, paragraph 2 of the Stabilization and Association Agreement, which refers to the ownership of agricultural land.⁶¹

The third part of the Constitution of the Republic of Serbia, relating to economic planning and public finances, states that the economic order of the

⁵⁶ Serbia has a favorable geographical location, duty-free exports to the Russian Federation and the countries of Southeast Europe, as well as the low rate of corporate tax, which amounts to 15%. Serbia has a free trade agreement with Russia, Belarus and Kazakhstan, as well as CEFTA countries (Albania, Bosnia and Herzegovina, Macedonia, Moldova, Montenegro, Serbia, Croatia, Interim Administrative Mission in Kosovo), EFTA (Norway, Liechtenstein, Iceland and Switzerland) and Turkey.

⁵⁷ Đ. Popov, *Kako do strategije razvoja Srbije?*, Zbornik radova Pravnog fakulteta u Novom Sadu, 2/2014, 7.

⁵⁸ *Ibid.*

⁵⁹ Đ. Popov, *Strane investicije multinacionalnih kompanija i ekonomski razvoj*, Zbornik radova Pravnog fakulteta u Novom Sadu, 3/2013, 15.

⁶⁰ Đ. Popov, *Kako do strategije razvoja Srbije?*, 17.

⁶¹ *Ibid.*, 17.

Republic of Serbia is based on a market economy, an open and free market, the freedom of entrepreneurship, the independence of business entities and the equality of private and other forms of property.⁶² Articles 84 and 85 of the Constitution are also of great importance for foreign investors. Article 84 regulates the position in the market. In this sense, it is prohibited to restrict the free competition by creating or abusing monopolistic or dominant position. The rights acquired through investments pursuant to the law cannot be reduced. The Constitution also provides that foreign entities are equal to domestic entities in the market. From the perspective of foreign investors it is very important to be able to acquire real estate property, and concession rights for natural resources and goods of general interest, as well as other rights provided by law.⁶³

Since the Constitution of the Republic of Serbia stipulates that foreign entities are equal to domestic entities in the market, the country is, thus, sending positive signals to foreign investors. Serbia, like other countries that are facing development problems, provides incentives to attract foreign investment. The law on regional development defines an incentive as a specific investment or an investment controlled by the state and directed towards projects of special importance for regional development.⁶⁴

Directly related to the previous is the Law on Investment⁶⁵, as well as the Regulation on Terms and Conditions for Attracting Foreign Investment.⁶⁶ The Law on Investment refers to both foreign and domestic investments.⁶⁷ The Law on Investment provides rights for investors, namely: investment freedom, protection of acquired rights, a guarantee that the investment will not be subject to expropriation (with the provision that the very property and other proprietary rights of investors in real estate may be suspended or restricted only in the public interest with the payment of an adequate compensation without delay), the principle of national treatment, freedom of international payments, the right to transfer profits and property of foreign investors as well as the consensual resolution of disputes. The Law on

⁶² Art. 82 (1) Constitution of the Republic of Serbia, *Official Gazette of the Republic of Serbia*, No. 98/2006.

⁶³ Art. 85 Constitution of the Republic of Serbia.

⁶⁴ Law on Regional Development (*Zakon o regionalnom razvoju*), *Official Gazette of the Republic of Serbia (Službeni glasnik RS)*, No. 51/2009, 30/2010 and 89/2015.

⁶⁵ *Official Gazette of the Republic of Serbia*, No. 89/2015.

⁶⁶ *Official Gazette of the Republic of Serbia*, No. 28/2015.

⁶⁷ The Law on Foreign Investments and certain provisions of the Law on Regional Development ceased to exist after the entry into force of this law.

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Investment, in addition to providing financial assistance, shows the importance of practical help provided by local, and provincial authorities.

It is interesting to note that the Law on Investment provides a definition of investment⁶⁸, which is also given in the Foreign Exchange Act⁶⁹ passed before the Law on Investment. Even more interesting is that the Decree on Terms and Conditions for Attracting Direct Investments contains a definition of investment. This is basically illogical, bearing in mind that the definitions found in the Foreign Exchange Act are more precise.⁷⁰ One of the peculiarities of the law is that it makes a distinction between investments of special importance for the Republic of Serbia and investment of local importance. The legislator recognizes the importance of incentives for economic development and for encouraging the investment environment, and provides the following incentives:⁷¹ state aid,⁷² tax incentives and

⁶⁸ It is important to note that this law, in contrast to earlier laws, does not consider investment to be a fine or other claim that arises directly from the commercial transaction (sale, exchange, service delivery etc.), a financial claim arising from the loan in connection with the commercial transaction (trade finance, etc.), or the portfolio investment. We believe this to be a good thing since Serbian legislation used to have a very broad understanding of the concept of foreign investment and the foreign investor. It included both direct and indirect investments and even such forms of investments that could practically be considered contracting businesses. Experts have warned us that such state of the matter is not good and that the definition should be narrowed down to an optimal level, because FDI are under particular legal protection of the host country. These questions are important because such a broad concept of foreign investment often causes the host country to be the defendant in investment disputes and usually the responsible party. More on this matter: M. Vasiljević, *op.cit.*, 27-46.

⁶⁹ *Official Gazette of the Republic of Serbia*, No. 62/2006, 31/2011, 119/2012 and 139/2014.

⁷⁰ R. Vukadinović, *op.cit.*, 155.

⁷¹ Art. 13 of the Law on Investment.

⁷² Since state aid represents a form of investment incentives, the Regulation on State Aid (*Official Gazette of the Republic of Serbia*, No. 13/2010, 100/2011, 91/2012, 37/2013 and 97/2013) provides the following forms of state aid: regional, horizontal, sectoral state aid, and state aid of small value. It is interesting to note that regional state aid can be granted for initial investments and new jobs openings connected to them, which represents regional investment aid. Regional aid also refers to newly created small businesses and operating costs. In the context of investment incentives, the above mentioned. The Regulation, among other things, provides for state aid for innovative clusters, which can be granted as investment or operational; the investment one being more important from our point of view.

deductions,⁷³ exemptions from taxes,⁷⁴ customs facilities,⁷⁵ as well as the system of compulsory social insurance.⁷⁶ The beneficiaries of these incentives

⁷³ The Law on Corporate Profit Tax provides investment incentives (*Official Gazette of the Republic of Serbia*, No. 25/2001, 80/2002, 80/2002, 43/2003, 84/2004, 18/2010, 101/2011, 119/2012, 47/2013, 108/2013, 68/2014, 142/2014, 91/2015 and 112/2015). More precisely it provides tax exemption for a ten-year period. Namely, taxpayers who invest in their fixed assets, i.e. and fixed assets that another party invests in more than a billion dinars, and permanently employs more than 100 people during the investment period, is exempt from paying legal entity profit tax for the period of ten years in proportion to investment. Investment in fixed assets is considered to be investment in the share capital and increase of the share capital in accordance with the law. The Law on Individual Income Tax is also one of the laws that provides tax relief for hiring new persons and persons with disabilities (art. 21v, 21g and 21d of the Law on Individual Income Tax, *Official Gazette of the Republic of Serbia*, No. 24/2001, 80/2002, 80/2002, 135/2004, 62/2006, 65/2006, 31/2009, 44/2009, 18/2010, 50/2011, 91/2011, 7/2012, 93/2012, 114/2012, 8/2013, 47/2013, 48/2013, 108/2013, 6/2014, 57/2014, 68/2014, 5/2015, 112/2015 and 5/2016).

⁷⁴ In accordance with the Law on Administrative Taxes, *Official Gazette of the Republic of Serbia*, No. 43/2003, 51/2003, 61/2005, 101/2005, 5/2009, 54/2009, 50/2011, 70/2011, 55/2012, 93/2012, 47/2013, 65/2013, 57/2014, 45/2015, 83/2015, 112/2015 and 50/2016.

⁷⁵ The Law on Customs provides for customs facilities such as exemption from import duties. This is why it is important to mention article 128, paragraph 1, which states that import duties are not to be paid for new equipment, produced out of the country and imported for the purpose of establishing new production or expanding the existing one. It also refers to equipment for modernizing the production process, introducing new technology or modernizing the existing. However, this does not apply to passenger cars or slots for entertainment or games of chance (Law on Customs, *Official Gazette of the Republic of Serbia*, No. 18/2010, 111/2012 and 29/2015). Based on article 219 the Government of the Republic of Serbia had the right to determine terms, conditions and procedures for exercising the right to exemption from import duties. The Government used the right granted by the Law by November 31 2015, based on the Decision on determining the goods that import duties are not to be paid for (*Official Gazette of the Republic of Serbia*, No. 124/12, 106/13 and 143/14). The period of validity of this law coincided with the beginning of the full liberalization of trade in accordance with the existing agreements on free trade, which enabled business entities to import equipment at preferential regime, i.e. without paying customs duties even after the expiry of the measure (Act of Custom Authority No. 148-I-030-01-120/3/2016, 17.03.2016).

⁷⁶ Certain forms of incentives are provided for by the Law on Contributions for Mandatory Social Insurance which refers to a refund of part of paid contributions for newly employed persons and December 31 2017 is the time limit (art. 45(1) of the Law on Contributions for Mandatory Social Insurance, *Official Gazette of the Republic of Serbia*, No. 84/2004, 61/2005, 62/2006, 5/2009, 52/2011, 101/2011, 7/2012, 8/2013, 47/2013,

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are legal entities and natural persons, payers of taxes and contributions and other public revenues. It should be noted that the incentives mentioned in the law are mainly incentives that already exist and have been introduced by other regulations.⁷⁷ Customs facility is the only novelty among the incentives. It means that the importation of equipment, which represents the investment of the foreign investor, is free. This does not apply to passenger cars and slot machines for entertainment and games of chance.⁷⁸ One of the novelties in the law, which led to some disputes, refers to information of public importance in the field of investment. This has been regulated by the Law on Free Access to Information of Public Importance.⁷⁹ Before this legal solution, the Government used to make discretionary decisions whether to disclose information about investments or not.

The Law on Investment gives a particularly important role to the local / provincial authorities in assisting the investors.⁸⁰ The assistance refers to urgent processing of all the documentation so that necessary public documents could be issued based on them (urgent action). The Law also

108/2013, 6/2014, 57/2014, 68/2014, 5/2015, 112/2015 and 5/2016). These incentives were previously provided for by the Decree on Employment Incentives which ceased to exist.

⁷⁷ Besides the aforementioned laws, investment incentives, i.e. subsidies were provided for by the Law on Employment and Unemployment Insurance. Employment subsidies are funds that the employer provides for the employment of individuals in the forms of new job openings and job vacancies, in case of individuals belonging to the category of the people of low employability (people with disabilities) in accordance with this law and the Action Plan, in the second case envisaged by the Action Plan. The contract regulates mutual rights and obligations of the National Employment Service and beneficiaries of subsidies (art. 50 of the Law on Employment and Unemployment Insurance, Official Gazette of the Republic of Serbia, No. 36/2009, 88/2010 and 38/2015).

⁷⁸ Art. 14 of the Law on Investment.

⁷⁹ Official Gazette of the Republic of Serbia, No. 120/2004, 54/2007, 104/2009 and 36/2010.

⁸⁰ It is interesting to note that some cities have given employment incentives of up to 2.500 euros for new jobs that would employ from 20 to 50 workers, 5.000 euros if 50 to 100 people would be employed and 7.000 euros if the new jobs would provide employment for over 200 workers. Some municipalities granted incentives in the following form: free utilities, giving plots of land at no charge, issuing permits rapidly, giving free location in the industrial zone for construction of business facilities for the period of 99 years, at no charge; exemption from paying local utility taxes, compensation for using municipal building land, compensation for change of the use of land, etc.

provides a series of measures to promote competitiveness of the local government.⁸¹

By adopting the new Regulation on Terms and Conditions for Attracting Direct Investments in 2015, the country is trying to promote and attract investments in order to improve the competitiveness of the domestic economy. The way towards reaching this goal is through direct investments, which should enable the opening of new jobs, the transfer of knowledge and technologies as well as the a balanced regional development.⁸² According to the text of the Regulation, direct investments, i.e. initial investments include investments in tangible assets (land, buildings, manufacturing plants, machinery, equipment) and intangible assets (investing in assets gained through transfer of technology-patents, licenses, know-how). They also include fixed assets of a company, in the manufacturing or the service sector, which can be subject to international trade and contribute to new job openings and economic development. This does not refer to some sectors excluded by the Regulation.⁸³ Incentives are therefore directed towards manufacturing which should be oriented towards the exports.⁸⁴ Direct investments refer to: commencement of new business activities; expanding the existing activities; diversification of the manufacturing program into new products, not included in the existing production program; significant changes in the overall manufacturing process of the existing business, or acquisition of assets directly connected to the company that has ceased to

⁸¹ Art. 17 of the Law on Investment.

⁸² Art. 1 of the Regulation on Terms and Conditions for Attracting Direct Investments.

⁸³ The funds for attracting direct investment cannot be used to finance investments in primary agricultural production, fisheries and aquaculture, transport, catering, gambling, trafficking, production of synthetic fibers, coal and steel, tobacco and tobacco products, weapons and ammunition, shipbuilding (building sea-going commercial vessels under its own power - at least 100 gross registered tonnes), the airport and the energy sector, broadband networks (Art. 4, para. 4 of the terms and conditions for attracting direct investment). The law on the allocation of funds excludes the following: a business entity in difficulty, companies that have outstanding obligations towards the Republic of Serbia, investors who own companies which significantly reduced the number of employees in the past 12 months preceding the application for funds, as well as the companies in which the Republic of Serbia, autonomous provinces and local self-government have a share of property (Art. 8, para. 1 of the terms and conditions for attracting direct investment).

⁸⁴ As a rule, the process of allocating funds involves a public notice within which the application for grants should be submitted. However, the new Law on Investments provides that for investments of special importance proposal of state aid is given without a prior public notice.

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exist or would be out of business if it were not purchased by a third party under market conditions.

The Regulation recognizes greenfield investments and brownfield investments. The first kind (greenfield investments) refers to building new production capacities and the second kind (brownfield investments) refers to investing in the existing manufacturing capacities, which would mean purchasing new machinery and/or new equipment. Brownfield investments are also related to the expansion, renovation or reconstruction of the existing production area or construction within it or within a technically related production facility on one or more cadastral land plots.

The Regulation refers to both foreign and domestic investments. In other words, incentives can be used both by domestic and foreign investors.⁸⁵ The funds allocated by the state are paid from its budget, or could come from international development aid.⁸⁶ Apart from this, funds can be used for manufacturing investments, but for the service sector subject to international trade, as well.

The above mentioned Regulation provides conditions for allocation of funds. It is necessary to keep the investment at the same location in the local government unit in which direct investment has been realized, for at least five years after the implementation of the project. For small and medium enterprises investments should be kept for three years after the completion of the project. The second condition is to maintain the number of the employed among the fund beneficiaries for at least five years after the implementation of the investment project, in large enterprises, and at least for three years in case of small and medium enterprises.⁸⁷ The amount of funds granted to the investor depends on whether the company is a small, medium or large enterprise.⁸⁸ Concerning the amount of funds allocated in the name of

⁸⁵ We can say that our regulations and practice used to treat foreign and domestic investors differently, which was not justifiable in any way. Foreign investments had better legal protection compared to domestic investments.

⁸⁶ Art. 4 (1, 2) of the Regulation on Terms and Conditions for Attracting Direct Investments.

⁸⁷ Art. 10 of the Regulation on Terms and Conditions for Attracting Direct Investments.

⁸⁸ The Regulation on Terms and Conditions for Attracting Direct Investment when it comes to small, medium and large enterprises refers to regulations for granting state aid. In this respect, the Regulation stipulates that a small business entity is the one found to have less than 50 employees and if its annual turnover and / or annual balance sheet total is less than 10 million euros in dinars. Medium business entity is the one that has between 50-250 employees and if its annual turnover is less than 50 million euros and / or its annual balance sheet total is less than 43 million euros in dinars. In contrast to the small

investment incentives, special rules apply to large investment projects, which include investments larger than 50 million euros.⁸⁹

Allocations are paid in three installments depending on available funds. The decision on the allocation of incentives is made by the Council for Economic Development.⁹⁰ Contracts on granting funds for financing incentives from the budget of the Republic of Serbia are concluded by the Ministry in charge of economic affairs. Funds are allocated as grants in order to cover the gross salaries, investments in fixed assets, intensive investment projects which create at least 200 job openings; additional incentives or funds can also be approved.

It would be appropriate to comment on such rules on incentives in the Decree. We should remind ourselves that the regulation provides for: state aid, tax incentives and deductions, and exemptions from taxes, customs facilities, as well as the system of compulsory social insurance. However, it provides for the possibility of allocating funds for attracting direct investment. In doing so, the amount of funds that can be granted to large enterprises is set to 50% of the eligible costs. For medium enterprises it is set to 60% of the eligible costs, and to the small ones to 70% of the eligible costs for the implementation of the investment project. It should be noted that these funds are allocated to both domestic and foreign investors. This still speaks in favor of the fact that our country approves major investment incentives. Alongside the fiscal incentives, our country approves significant financial incentives, as well. A justifiable question arises from all this: Are these financial incentives justified in Serbia since they can pose a significant burden to the country and are allocated from its budget and from its international development aid fund? International practice is such that financial incentives are typically granted in developed countries, while fiscal incentives are common in developing countries. Our country does not belong to the group of developed countries, but still it has decided to allocate funds as a form of incentive. This means that attracting investments is of particular importance to the country, which is not surprising, because Serbia is in need of economic growth and development. However, there still remains the

and medium, a large business entity is defined negatively, i.e. as a business entity that is not a medium or a small business entity (art. 2a of the Regulation on State Aid, *Official Gazette of the Republic of Serbia*, No. 13/2010, 100/2011, 91/2012, 37/2013 and 97/2013).

⁸⁹ Art. 6 of the Regulation on Terms and Conditions for Attracting Direct Investments.

⁹⁰ The Economic Development Council consists of the Minister of Economy, Minister of Finance, Minister for Labour and Employment, President of the Serbian Chamber of Commerce and Director of the Development Agency of Serbia.

question of the justification for this kind of incentive because it means that, at least in theory, investors can perform their activities in Serbia until the incentives are exhausted. Their investments are of short-term nature and once the incentives are exhausted, the investor can decide to leave Serbia.

5. CONCLUSION

Approval of investment incentives is a widespread practice among countries. However, we must point out that incentives should not be focused only on foreign direct investment, but also on domestic investment because otherwise it would constitute discrimination. Thus, the incentives must be equally available to foreign and domestic investors. Developing countries are, due to economic growth and development, as well as high debt, in need of both types of investments. Approval of incentives to attract FDI, is usually motivated by the desire to have spillover effects in the host country, such as the transfer of new technologies, know-how, performing of new economic activities and the like. Therefore those investments that are expected to have the strongest spillover effects should be attracted.

Incentives can be very expensive for the country that approves them, especially if incentives are the only motivation for investing. This means that these are short-term investments and incentives can be a big burden to public finances. Governments can approve incentives that have limited effectiveness under the pretext of attracting investments to underdeveloped areas, or regions and thus enhance the already existing inequalities.

Incentives are provided for by the laws of the Republic of Serbia. The law provides for both fiscal and financial incentives. From the perspective of the author, Serbia appears to be very generous when it comes to granting incentives since financial incentives are usually approved by developed countries.

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