Journal of Business Economics and Management
2003, Vol IV, No 1, 62-71

ISSN 1611-1699

GLOBALIZATION PROCESSES IN BALTIC COUNTRIES: ANALYSIS OF TRENDS IN LITHUANIA, LATVIA AND ESTONIA

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Received: 17 May, 2002

Abstract. The paper scrutinizes issues concerning factors determining inflow of foreign direct investments into Baltic States. It aims to determine what drives foreign capital to considered region, and if different approaches to conditioning business environment matter.

Keywords: foreign direct investments, business environment, tax systems, Baltic countries

1. Introduction

In the context of the European Union enlargement and the economic restructuring of candidate countries globalization processes have been especially emphasized The presented paper, on the one hand, has been aimed to determine what attracts FDI (foreign direct investments) to countries located in one geographical region, and, on the other hand, to outline impact of FDI on efficiency of functioning economic entities in Lithuania, Latvia and Estonia.

Despite common aims are obvious, each considered country has chosen rather different way of transition.

One of peculiarities of implementation of transition reforms constructing of their tax systems reflect. All considered countries have emphasized importance of attracting of foreign capital and have tried to create favorable investment environment through appropriate tax concessions. Targeting at the same objectives the countries have applied different economic approaches to own tax reforms. Hence, Latvia developed its tax system according to suggestions of international organizations; Estonia choscd absolutely extraordinary approach of tax reform and Lithuania has found herself in the crossroad of quite oppositely directed alternative projects of tax reforms.

Presented paper scrutinizes approaches to constructing of tax systems in Lithuania, Latvia and Estonia and aims to evaluate their impact on globalization processes.

2. Theoretical background of the research

Among some academicians and majority of policy makers an unquestionable belief in special importance of FDI prevails. Promoting FDI, in their opinion, targets endeavoring gains offered by globalization: transmission of know-how, modalities of corporate governance, access to specific knowledge etc.

Favoring of FDI, or foreign control of productive assets, means putting emphasis on one mean of achieving global market integration - against such ones, as increased trade, licensing of technologies or portfolio investment. Assessing the impact of globalization through FDI on host-countries economies is a big and complicated task, which is hardly plausible to compete in full. Nevertheless, even approach to rough evaluation would help to improve policies directed toward promoting FD1 answering the questions: where should host authorities focus their attention as they design policies to maximize benefits and avoid the dangers imposed by incorporating FDI into their development strategics.

To begin, we provide background on theory about the impact of FDI on development. Later we discuss factors determining the location of multinational production. Those two strands of theoretical discussion we will use as a framework for detailed studies of evidence from Baltic countries.

Two alternative approaches to the impact of FDI on host-country economy could be found. The first suggests that the arrival of multinationals may help speed up the process of industrial development by helping to increase productivity. Underdeveloped country is seen as one stuck in vicious cycle: low levels of productivity lead to low wages, which lead to low levels of saving, which lead to low levels of investment, which perpetuate low levels of productivity. FDI can improve situation by complementing local savings and by supplying more effective managing, marketing and technology to increase productivity. The gain obtained by national economy depends on the size of capital inflow, the elasticity of the demand of capital and magnitude of spillovers. Spillovers or "contagion" effect [1] from more advanced foreign company can lead to improvements in productivity in several ways. The first, the local firm can improve its productivity by copying some technology. The second, local firm can be forced to use existing technology more efficiently or to search for new technologies because of increased competition in market. The third, multinational can train local workers, who later accept employment in local firms. Another significant channel for spillovers is through the linkages between multinational and its local suppliers and customers [2] ; [3]. Being channels for spillowers forward and backward linkages doesn't exclude additional impact on local firms: multinationals also may increase competition for local firms, and thus may redistribute income away from some groups [4].

A multitude of facets of impact of the same factor determined prevailing among some researchers of opposite approach to the impact of FDI on host-country economy. This approach in principle is consistent with the malign view of FDI and more characteristic for earlier years. According to this view, multinationals are oligopolistic companies, locating in protected markets with high barriers to entry and increasing market concentration. They extract rent, shiphon off capital through preferred access to local capital markets, and drive domestic producers out of business [5]. In addition they repatriate profits and drain capital from the host economy. FDI, according to this view, don't encourage economic growth and efficiency spillovers. In contrary, the high probability is seen, that they would support a small oligarchy of indigenous partners and suppliers, use inappropriate capital intensive technology in a labor surplus context, producing a small labor elite while many workers remain unemployed or underemployed. Despite this view of FDI isn't emphasized in recent studies, the plausibility of negative impact of multinationals on the profitability of domestic firms and on host-country welfare still is allowed [6].

Despite there is no consensus on the relationship between and FDI and growth, there is a growing view in recent years that FDI, in principle, is positively correlated with growth.

For either of presented above approaches to be used as the model of interaction between FDI and host country economy development requires a set of assumptions, most having to do with how competitive the industry and economy are where FDI takes place.

In the theory of FDI the prevalent assumption is that for firms to operate outside their own home economy, they must posses some sort of specific advantages. Following [7]; [8], a firm must own or control a unique mobile asset (e.g. a patent or trademark) it wishes to exploit *(the ownership advantage);* it must be cost efficient to exploit the asset abroad in addition to, or instead of in, the firm's home country *(the location advantage);* and it must be in the firm's interest to control the asset's exploitation itself, rather than contracting out use of the asset to an independent foreign firm *(the internalization advantage).*

Other conventional reasons why firms prefer to internalize are expressed by [9]. Concisely, according interests FDI could be grouped to "horizontal" or market seeking FDI and to "vertical" or "production-cost minimizing" FDI. There "horizontal" FDI normally involves building plants to supply host-country market. The stimuli arc: the first, reducing cost through avoiding trade tariffs and diminished transport costs, and, the second, becoming more competitive through obtained possibility to respond to changing local circumstances and preferences. "Vertical" FDI usually involves relocation part of the chain of production in a low cost country. "Vertical" FDI also has features of what is commonly called "raw material seeking FDI" since inexpensive raw materials together with labor, intermediate goods represent low cost input. Access to certain externalities, e.g., cluster of FDI in one location (sometimes referred to as "agglomeration"), which can lower costs for final producers [10] also serves as determinant of "vertical" FDI.

The framework above suggests a list of factors, which may be important in attracting FDI, such as economic distance, market size, agglomeration effects, factor costs, fiscal incentives, business environment climate, economic stability, trade barriers.

While these factors arc likely to affect all types of FDI, the different strategic objectives of different multinationals are implicit (e.g. [11] asserts that more than 50% of the manufacturing investments in emerging economies by Danish companies were made with the objective of selling goods on these markets, and only 18% were made with the objective of reaping the benefits of lower production costs).

That suggest that certain factors may affect one multinationals and another factors may more affect another and even more, this combined impact could be different in different regions (e.g. according [12], within the EU, FDI responses strongly to tax rate differentials relative to FDI between the US and the rest of the world). Combinations of different determinants of FDI, in its turn, most likely result different impact on welfare enhancing of host country economy.

The focus on legal environment of Baltic countries has been motivated by a aim of paper: to verify if different approaches to tax system could be considered as major determinant of FDI for this specific region.

3. **Methodology of analysis**

Tax system is notoriously quite significant tool of regulation of any economy, which affects propensity to invest. Nevertheless, explicit impact of it on investment environment cannot be measured and must, therefore, alas, be traced only indirectly through analysis of major economic indicators.

Presented paper is based on a following approach to considered problem. At first, we make a conjecture that tax systems of all analyzed Baltic Countries were constructed aiming to attract foreign direct investment (FDI), so taxation of corporate profit would be examined quite thoroughly.

We realize, that probability is, that FDI to transition countries can be attracted not only by favorable investment conditions from the point of taxes but also by other factors. Nevertheless, we need to admit that a lot of indexes characterizing Baltic countries fluctuate within narrow limits, hence, in our paper wc have focused on investigation of driving factors embracing legal environment conditioned by different tax systems.

The rationale of analysis of FDI in the context of valid tax systems is obvious: more favorable than in other countries conditions should attract international investment capital. In its turn additional capital should induce grow of GDP. Hence, another aim of paper is to verify if actually appropriate relationship between FDI and GDP exists. It is possible that the lack of a positive relationship between those indicators reflects inefficiency of FDI resulted by occupation of monopolistic positions in all or some transition countries - a conjecture that we explore below.

The upshot of this comparison should be evaluation of level of actual impact of taxes on investment propensity in Lithuania, Latvia and Estonia. Considering complexity of a task of evaluation of impact of one factor, especially such as tax system, on displayed propensity to invest, we accept following approach: if growth of FDI is followed by growth of GDP that could be treated as situation when FDI attracted by favorable investment conditions induce GDP growth; if increase in FDI weren't be followed by growth of economy that would mean that FDI simply occupied monopolistic positions and don't contribute properly to the growth, so, tax system wasn't major factor stipulating FDI.

We conclude the paper by evaluation of impact of different tax systems on economies of Baltic States and discussing the policy implications of the analysis.

4. Investigation of Different Tax Systems And Investment Processes in Baltic States

4.1. Lithuanian Tax System, FDI and GDP trends

Lithuania actually began its tax reform in 1990, when Law of Profit Tax of Legal persons was passed, and profit tax tariff equal to 35% was set (until that profit share directed to state budget was determined according rules of central planning). In 1991 profit tax tariff was reduced to 29%. In 1993 an important turn to stimulation of investments was made: profit invested back to enterprise was due to reduced taxation. For investments only 10% profit tax tariff was applied.

From 1993 to 1995 conditioning of legal environment was directed towards differentiated taxation of investments according to origin of capital invested. With purpose to provide additional benefits for foreign capital amendment of law was introduced. According to it if enterprise was established (registered) or foreign capital was invested before 31 December 1993, the part of its profit (income) proportional to the share of foreign investment in the enterprise's authorized capital due to that investment and not used for labor costs, and reinvested in the enterprise, shall be taxed for five years by profit tax reduced by 70%. On the expiration of this five-year period the part of profit (income) due to foreign investment shall be taxed for another three years by profit tax reduced by 50%. Consequently, local investors, despite above pointed out profit tax deductions on investments, comparing with foreign investors were discriminated.

In further actions in the sphere of conditioning of investment environment government continued demonstrate inconsistency. It was regulated that in case an enterprise was established or foreign capital invested since 1 January 1994 until 1 August 1995, profit (income) due to foreign investment shall be taxed for six-year period by profit tax reduced by 50%. At this point business conditioning didn't stop.

Government changed attitude to foreign investors in general and made emphasis only on quite considerable investments. Additional condition was introduced: if foreign investor have invested foreign capital worth at least $ 2-million until 1 April, such enterprise shall remain exempt from corporation (profit) tax for three years from the moment the profit is received and will benefit from 50% reduction in profit tax during the subsequent three years.

In 1998 business conditions for local investors changed cardinally. It was decided to abolish application of profit tax on taxable profit used for investment purposes. Frequent change of political influences and lack of deliberated and grounded long-term economical policy resulted situation in which business subjects operating in the same market have been subject to different rules of taxation (Table 1).

It's difficult to judge if it was complicated scheme of exemptions presented above that stipulated grow of investments. The impact of various profit tax concessions was weakened by loopholes letting to transfer funds into various offshore companies and under shed of various consultation and etc. services to inflate costs of functioning of business firm.

Only in 1997 Resolution was passed imposing tax on funds transferred to countries of low taxes (only recently this tax has been diminished from 29 to 15%).

Growth of foreign investments in Lithuania could be considered as quite significant. This being the case, positive impact of it should reflect in other major economic indicators, especially, such as growth of GDP (Fig 1).

According above presented statistical data, direct foreign investments without account of investments of local private capital, in year 2000 comprised 23,9% of GDP. For comparison, according EU-15 aggregated data, gross fixed capital formation by the private sector, as a percentage of GDP in 1998 was 17,6% and in 1999 according 17,9% [13].

Despite impressing growth of investments as share of GDP, trends of presented economic indicators leads to controversial corollary: stimuli for foreign investments seems have worked but corresponding to them growth of national economy hasn't been generated. As concerns interpretation of current situation several assumptions arise. The first, drop in rates of grow of GDP has no relationship neither with foreign investments nor with local investments. The second, investments haven't been efficient and haven't contributed to the increase of national economy. The latter premise seems trustworthy and could be confirmed by general concern of Lithuanian government to attract foreign capital to privatization of already functioning state enterprises at any price: privatization could offer "quick money" to budget while investment into "green

Table 1. Legal Environment of Operating Business Firm Stipulating Stimuli for Investment

Date	Origin of Capital	Basic Profit Tax Tariff	Tax Deductions	Comments
Since 1 July 1993 until 1 March 1997	No difference	29%	Taxable profit invested is taxed by "10" profit tax tariff	
Before 31 December 1993	Foreign	29%	5 years profit tax reduced by 70%, next 3 years profit tax reduced by 50%	Tax deductions applied with no connection of amount invested
Since 1 January 1994	Foreign	29%	6 years profit tax reduced by 50%	Tax deductions applied with no connection of amount invested
Until 1 April 1997	Foreign	29%	Exempt from profit tax for 3 years from the moment the profit is received and will benefit 50% reduction in profit tax during next three years	Foreign capital invested shall be worth at least $2-million
Since 1 March 1997	No difference	29%	Taxable profit invested is taxed by "0" profit tax tariff	Any additional exemptions for capital of foreign origin
Since 1 January 2000	No difference	24%	Taxable profit invested is taxed by "0" profit tax tariff	Any additional exemptions for capital of foreign origin

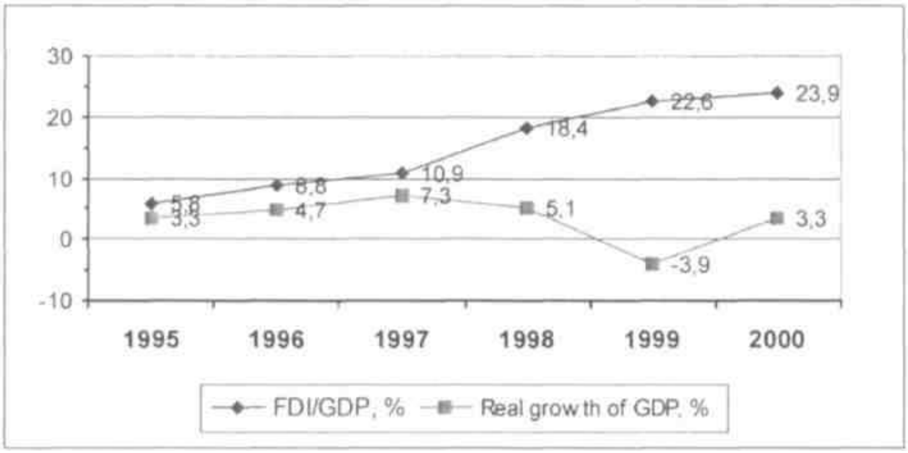

Fig 1. Analysis of Relationship Between Growth of FD1 Measured as FDI/GDP, (%) and Real Growth of GDP in Lithuania [14]

field" would generate macroeconomic results only in long-run prospective. Dynamics of growth of foreign investments, measured as share of GDP, could be treated as aftermath of bias economical policy in this field expressed by turn to privatization of key monopolistic enterprises of strategic industries in extremely favorable conditions. The result was quick budget revenue without any guarantees for future economic growth. As illustration could serve in 1998 signed privatization contract with Amber Teleholdings (consortium of Sweden "TELIA" and Finland "SONERA") into which a purchase of 60% of shares of Lithuanian Telecom for 2.4 milliards litas and obligation to invest another 884 millions during next two years has been included. Despite high profitability of Lithuanian Telecom before privatization government obligated to guarantee monopolistic position for privatized enterprise until year 2002. Mažeikiai Oil Refinery is another example of large-scale privatization in conditions especially harmful for Lithuanian economy. As concerns "green field" investments, they apparently comprise rather insignificant part of direct foreign investments. That confirms that government policy hasn't been directed towards enhancing of production potential of country, but instead has tried to solve budget problems without sufficient emphasis on long-run development of national economy.

Slow down of growth of national economy as well as Increase in unemployment rate once more time riveted governments attention to new investments. Concern resulted in new Government Program for year 2000-2004. In it abolishing of profit tax and taxation of dividends by 24%, instead, have been foreseen. Also equal approach to foreign and local investments has been confirmed.

Despite the official tack in the field of tax reform officially was set, diametrically opposite opinion concerning future reform were discussed. One of reasons of fall of government in the end of June was disagrccment in choosing of general economical policy. So, less than a year ago formed government fell; new majority in Parliament took power into its hands. New tack was announced: introducing of progressive profit tax and abolishment of all tax concessions on capital invested would be more effective. Turn into new economical policy isn't put into legal form yet, but still it is obvious that Lithuania haven't principally decide what approach to tax reform to accept due to induce growth of effective investment and growth of GDP.

4.2. Latvian Tax System, FDI and GDP trends

The taxation system of Latvia different from Lithuania has been set up in accordance with recommendations provided by international financial organizations. The general rules and principles of taxation are described in the Law "On Taxes and Duties" adopted in 1995. A set of taxes are very similar to Lithuanian, so considering our aspect of investigation, the main emphasis we will put on taxation of profit of business enterprises. In Latvia profit of firms is taxed according Corporate Income Tax law adopted on 1 March 1995. Corporate income, or to put in other way -profit - is taxed by 25%. Tax tariff doesn't differ much from Lithuania (as it was showed above, in Lithuania recently 24% profit tax rate is applied). The main point of interest for comparison purposes were profit tax concessions directed towards inducing investment stimuli. Hence, Latvian investment stimulating policy is realized through following profit tax concessions. The first and the most important tax concession on capital invested is: companies involved in supported investment projects arc granted 40% reduction of their corporate income tax. The main condition to get the tax reduction is that investment project was the Cabinet of Ministers, amount of the project exceeded 10 millions lats, and the investments were done within 3 years period. Tax reduction is applied only in the year when the investments are finished.

Comparing Lithuanian and Latvian approaches to conditioning of investment environment significant difference can be found. Latvia is going to apply profit tax concessions only on projects supported by government and only after planned large-scale investments are fully implemented. Lithuania, in its turn, offers various special conditions for big projects, and additionally applies tax allowances on any amount of capital invested. In Lithuanian case natural conjectured arise: business firm could be tempted to inflate its capital costs. Then possible results not necessarily include increase of efficiency of operation of business firm. On the other hand, the great probability is that budget revenue collected from profit tax can diminish significantly - a conjecture that we'll explore below.

The second great difference in approach to tax reform comparing Lithuania and Latvia is that Latvia beginning from 1st of January 2001 has turned to stimulating statc-of- the- art industries and informatics products. In Latvia companies producing hi-tech products and hardware-software products are granted a 30% tax reduction of the calculated corporate income tax. This tax break is applicable only in cases, where 75% of a company's output consists of the above-mentioned products and the company has ISO 9000, ISO 9001 or ISO 9002 certification.

The third important difference of Latvian tax system is that latter is oriented to development of lagging behind regions. Enterprises established in specially supported regions could apply additional rates for the depreciation of fixed assets. So, multiplying value of fixed assets invested in supported regions by appropriate coefficients ranging from 1,5 to 2 leads to increase of depreciation costs and accordingly, reduce payable corporate profit tax. Even more, business firms invested in problematic regions may transfer losses from year to year within a 10-year period.

Such economic tool used in Latvia assumingly should induce increase in GDP of county through attracting investment into less developed regions. Latvia also differently from Lithuania supports various business projects. In Latvia expenses for research and development (including those connected with technical documentation of un-implemented projects, if the value of such projects does not form part of fixed assets), which are connected with the entrepreneurial activities of the taxpayer, are written off in the year generated.

Generalizing it could be stated that Latvian approach to corporate profit taxation is based on smaller and more concrctc-purposc-oriented concessions.

In Table 3 economical data reflecting growth of FDI and GDP in Latvia are presented.

Comparing to Lithuania Latvia managed to achieve higher FDI per capita by year 2000: as we saw in Table 2, in Lithuania FDI per capita was $ 727 versus $ 875 in Latvia. As concerns rates of growth of FDI, in Lithuania during period 1995-2000 FDI per capita increased almost 6 times comparing to increase of 3,4 times in Latvia.

Hence, corollary could be made that Lithuania had stronger stimuli of attracting FDI into country. As concerns effectiveness of those investments, growth of GDP together with growth of FDI should have been considered (Fig 2).

Presented comparison of trends of change of FDI and GDP leads to corollary: in Latvia FDI affect growth of FDI insufficiently, though slightly more than in Lithuania.

In Latvia in the mid-1990s major investments were made in port facilities and telecommunications, largely based on privatization. Later due to acceleration to

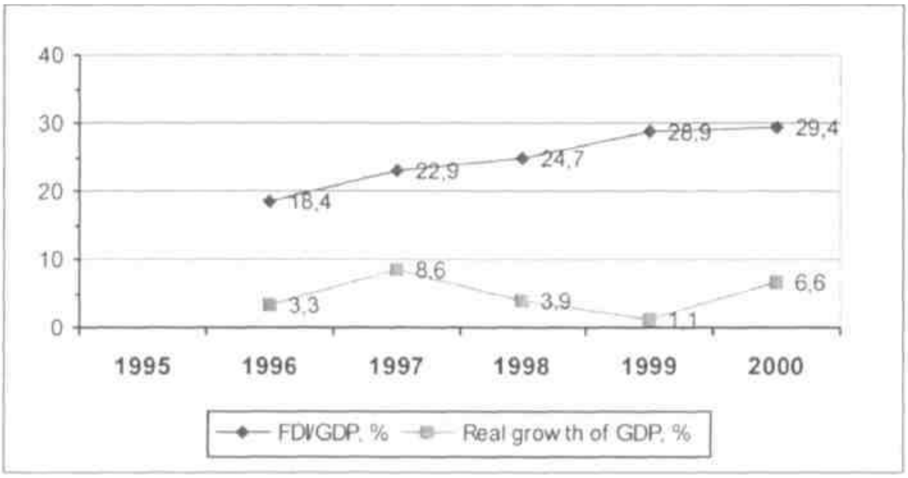

Fig 2. Analysis of Relationship Between Growth of FDI Measured as FDI/GDP, (%) and Real Growth of GDP, (%) in Latvia [15]

privatization process, investments in manufacturing increased. In 1988 major investments were made in the financial sector and the development of the whole-sale/retail trade network. What is common with Lithuanian pattern of FDI, in Latvia also a high ration of it have come through privatization process.

Hence, generalizing it could be said that FDI attracted both by privatization and favorable investment conditions haven't guaranteed appropriate acceleration of GDP growth. Slightly tighter relationship between share of FDI in GDP and GDP growth in Latvia could signal that tax system oriented to achievement of more concretely formulated purposes worked a little bit more efficiently. Nevertheless, taking into account that tax system is not a single factor affecting propensity to invest we'll make final decision about tax policy implications after consideration Estonian tax system and appropriated trends in FDI and GDP change.

Estonian Tax System, FDI and GDP trends

Considering Estonia's approach to tax reform it should be signified that it differs a lot from its neighbors Lithuania and Latvia.

Estonia from the very beginning of transition turned to stimulating of FDI. In 1994 special tax incentives granted to companies with foreign investment were abolished.

In October 1997, the Parliament adopted a law of amendments to the income tax law allowing the Government to determine regional investments subject to tax concessions. Companies could deduct expenses made to acquire or upgrade fixed assets and equipment from taxable income. From January 1998 up to 31 December 1999, the tax concessions were applied to investments made in a lagging behind regions. The corporate entities were able to deduct from their taxable payments the losses attributable to this incentive.

From 1 January 2000, resident companies and permanent establishments of the foreign entities (including branches) arc subject to income tax only in respect of all distributions (both actual and deemed). To put in other words, from the January 2000, instead of taxing the profit of legal persons, the distribution of profits as well as transactions, which can be treated as hidden distribution of profits, is taxed. It means that corporate profits have been set free from income tax. The basic idea underlying the income tax exemption is to promote the development of Estonian economy and enterprises while making available extra funds for investments. The regional income tax incentives introduced for the under-developed regions of Estonia in 1998 arc abolished from 1 January 2000.

Unprecedented approach of Estonia to corporate profit tax has come in for a lot of criticism. The main arguments against extraordinary economic reform were as following. At first lack of evidence coming from other countries was emphasized. The second, taking into account efforts of Estonia to join European Union, absolutely different tax system seemed a little bit unexpected (though directives of European Union don't arise any requirements to corporate profit taxation). The third some doubts were expressed about difficulties of implementation of unusual law into practice.

Anyway, evaluating efficiency of tax reforms in Estonia it should be emphasized that in this Baltic State growth of share of FDI in GDP is followed by appropriate increase in GDP. That could be treated as healthy tendencies corresponding economical rationale. Even more, in Estonia the smallest share FDI/GDP ratio corresponds the highest GDP growth rate. As it was showed above e.g. for year 2000 for Lithuania FDI/GDP equal to 20,8% corresponded 3,3% of GDP growth, In Latvia those indicators were 29,4 and 6,6,

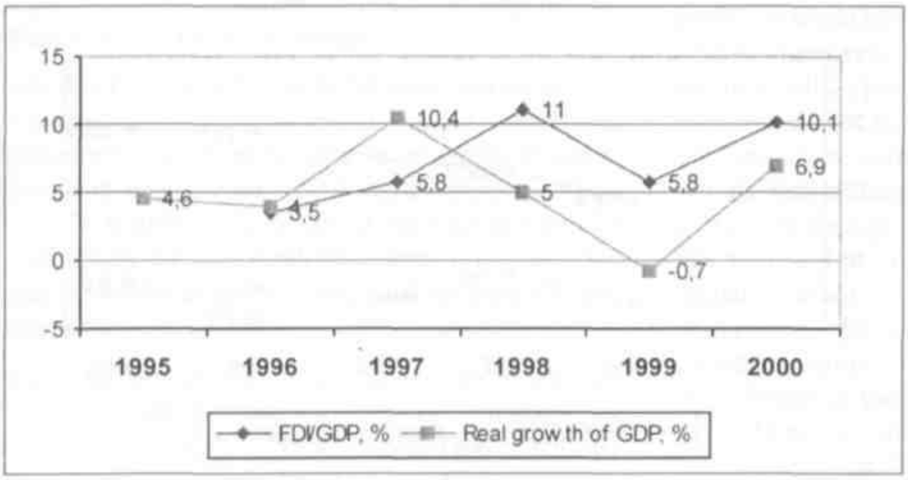

Fig 3. Analysis of Relationship Between Growth of FDI Measured as FDI/GDP, (%) and Real Growth of GDP, (%) in Estonia [16]

while in Estonia FDI/GDP share of 10,1% was found together with 6,9% of GDP growth.

Evaluation of Impact of Tax System on Foreign Investments and Growth of National Economies in Young Transition Countries

Economic rationale says that additional inflow of investment should bring about an increase in GDP. Comparing of economic data of Lithuania, Latvia and Estonia let to reveal quite controversial situation: Lithuania displays the lowest efficiency of rather high index of FDI; even more growth of FDI seems to be followed by slow down in GDP growth. A peak this tendency in Lithuania reached in 1999 year, when high FDI/GDP rate (22.6%) appeared together with a significant drop in growth of GDP (by 3,9%).

Latvian situation slightly differs. Latvia's even a little bit higher rate of FDI (29,4%) brings about twice higher rate of GDP growth (as it was mentioned, 6,6% in year 2000). In generally, Latvian FDI and GDP trends gives signals about roughly correspondence of them to economical rationale.

Estonia with some deviation could be treated as country developing according economic logic: increase in GDP could be considered as sufficiently sensitive to growth of FDI, which, in its turn, measuring it in FDI/GDP terms, is much more modest.

So we revealed quite controversial situation in Field of FDI and GDP growth in young Baltic Countries. A question arise: why Lithuania with the most favorable for investors tax system displays the worst results, Latvia, having less favorable, but still quite investment oriented tax system, displays a little bit better situation, and Estonia, which only in year 2000 turned her tax politics from one with quite insignificant investment stimuli, managed to reach the best results.

Considering presented situation following conjecture arise: in young transition economies tax systems based on tax concession for investments don't play a proper role in attracting investments. In newly formed markets investments are stipulated by other factors, such as privatization of enterprises already having significant share of market. This being the case, share of FDI, directed to occupation of monopolistic positions, gains twice. At first, such firms of foreign capital can receive profit due to special position in the market rather than to increased efficiency; and second, being in monopolistic positions in country with significant tax concessions on investments additionally they can enjoy low taxes. So when significant share of GDP is attracted by privatization situation described above could arise.

Let's explore our conjecture. According data of privatization agencies of considered countries, in Lithuania during period 1996-1999 in Lithuania 36% of all FDI was received in result of privatization (e.g. in 1999 even 99% of all FDI comprised incomes from Telecom monopoly privatization, what corresponded - 3,9% GDP growth); in Latvia during the same period 30% of FDI was resulted by privatization, while in Estonia only 17% of FDI was received due to privatization of national objects.

Presented data tend to confirm our conjecture: significant tax concessions on investments in transition economies aren't so powerful tool of finally inducing economic growth as they are expected to be. Conditions of privatization also play very important role in determining of future efficiency of FDI. If transition country allows to investor to keep monopolistic positions in nearest future that hardly can lead increase of efficiency of operation in the market. The great probability exist that in transition countries conditions of privatization could be established due to high level of corruption. As concerns Baltic States, according evaluation announced by Transparency International in Annual Report 2000, The Corruption Perceptions Index for Lithuania equals to 3,8; for Latvia and Estonia accordingly equals to 3,4 and 5,7 (highest score is the best; e.g. for Denmark it equals to 10,0; for Finland - 9,8). So, presented evaluation of corruption also confirms our conjecture: Estonia being less corrupted comparing to neighbors display higher FDI efficiency.

Comparison of composition of FDI by country and FDI by sectors of economy in Lithuania, Latvia and Estonia also bears some information considering propensity to invest in concrete Baltic State. Presented data (Table 2 and, 3) send unambiguous signals that cluster of countries (Sweden, Denmark, Finland and USA) demonstrate almost identical interests (in communication, manufacturing, financial sector and trade) in Lithuania, Latvia and Estonia. That one more time confirms that in transition economies significant tax concessions on investments aren't so effective as was expected.

Table 2. Composition of FDI by countries [14], [15], [16]

FDI by Country, 2000 (% of total)	Lithuania	Latvia	Estonia
1. Sweden	21	10.2	37,6
2. Denmark	15	14	4,1
3. Finland	12	*	28.7
4. USA	9	9,3	4.5

Table 3. Composition of **FDI** by sectors of economy

FDI by Sector, 2000 (% of total)	Lithuania	Latvia	Estonia
1. Communication	27,7	24,5	27
2. Manufacturing	25	21	24
3. Financial Sector	**	21,5	23
4. Trade	19,7	17	16

* Large investments in Latvia were made by Denmark (however the majority of Danish investment is represented by consortium of SOWERA from Finland). ** in process of privatization

Before considering tax policy implications of the analysis, one more aspect of various approaches to investment stimuli should be deliberated: impact of tax concessions on national budget structure. The point of analysis of structure of budget revenue is in sustaining or disposing of an argument that tax concessions on investments in long term don't affect budget revenue. So, e.g. in Lithuania it have been repeated time and time again that tax concessions on investments had to induce growth of production, what in it's turn in long term would stipulate the same volume of taxable profit and, if not increasing then at least stable, same revenues from profit tax. Hence, in Fig 4 trends of share of GDP (%), in national budgets of Lithuania, Latvia and Estonia are presented.

Trends of GDP's share change disposes of an argument that tax concessions on investments in young transition country induce growth of production and maintain certain level of taxable profit. In contrary, the greater tax concessions, the greater drop in taxable profit. Latvia, e.g., with less significant tax concessions haven't experienced such a drop in share of profit tax in national budget. Estonia, in its turn, lost profit tax revenue after tax reform in the beginning of year 2000.

Conclusions

The main upshot of the comparison of tax systems in Baltic States is that, in general, young transition countries with especially favorable investment conditions, from the point of view of taxes, grow more slowly than countries applying more modest investment stimuli.

Such corollary might seem controversial for developed countries, but situation, in which young independent states found themselves after segregation from Soviet Union was different: all of them were at the very beginning of process of creating market relationships, enterprises of state capital dominated, private capital was in the stage of formation and operated in relatively uncompetitive environment. Such situation, at the one hand, stipulated intensive processes of privatization, and, on the other hand, offered for other developed countries chance of entering new markets actually free of strong rivals. Natural process of expanding activity into not occupied yet markets stipulated FDI. Another characteristic feature of entrance of foreign capital was that, at first, it flew into monopolistic spheres of economy. Favorable conditions for occupation of monopolistic positions were fostered by governments, which, drastically needed money and offered incredible favorable conditions of privatization (as the most characteristic example privatization of Lithuanian Telecom could be referred - the most profitable enterprise in Baltic countries was privatized with condition to guarantee monopolistic conditions till 2003 year). So process of privatization, sometimes followed by signs of corruption, stipulated that growth of FDI hasn't induced appropriate growth of GDP. This tendency was especially obvious in Lithuania, where role of privatization in attracting FDI was the greatest and level of corruption the highest. Hence, we

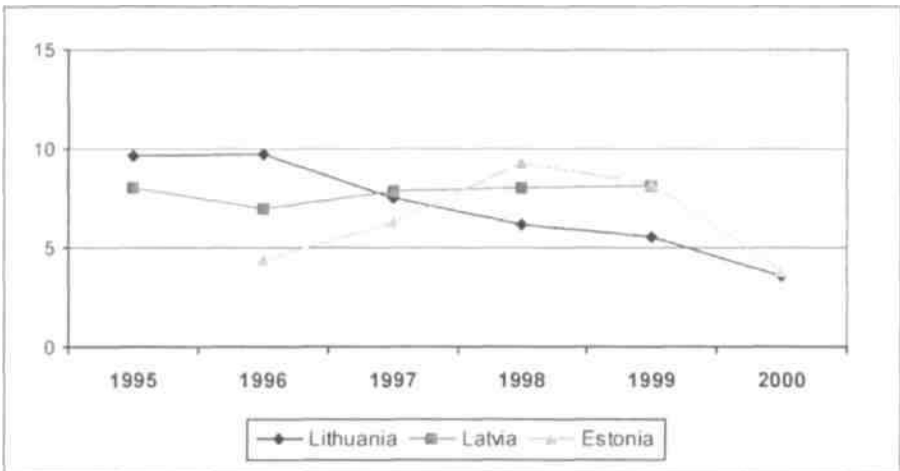

Fig 4. Share of corporate profit tax in national budgets of Lithuania, Latvia, Estonia [14], [15], [16]

can conclude that role of tax incentives in young transition countries case is diminished by other factors, and strongly investment oriented tax policies on the early stage of development of market can lead to diminishing of budget revenues from profit tax.

Presented comparison of tax systems in Baltic States Lithuania, Latvia and Estonia yields following tax policy implications: tax system, conditioning especially favorable investment conditions in young transition economics doesn't play the role, which was predetermined to it. So there is no point in introducing special tax incentives in forms of tax concessions on capital invested. As concerns tax rates countries arc free to accept any tariff. Authors of paper support progressive profit tax tariffs allowing but that is quite subjective matter. The main thing is to keep in mind that, according economic rationale, strong relationship between profit received by enterprise and volume of capital invested exists. So the main emphasis should be put on creation for favorable conditions of business firms operation without distinction of origin of capital invested. Firms, witch balance on the edge of profit and losses don't gain from tax concessions on capital invested at all, while profitable firms have possibilities escape taxes through inflating of capital costs.

So instead tax concessions on capital invested, young transition countries should concentrate on attracting "green field" investments by guaranteeing stability of once implemented business conditions, continuity of already started reforms and, what is not of less importance, reducing bureaucratic hurdles and increasing transparency of decisions of civil servants.

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