ALBANIA

TARGETING FOREIGN DIRECT INVESTMENTS TO EXTRACTIVE INDUSTRY THROUGH FISCAL POLICY

by

Fidan Bytyqi
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Author:
Fidan Bytyqi

Supervisor:
Yves Bourdet
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This paper is dedicated to my grandparents for their persistent encouragement to aim for knowledge.
Abstract

This study aims to study the policies and measures adopted in order to attract FDIs to the extractive industry and to maximize their effects on the Albanian economy. Emphasis is put on fiscal policy and the allocation of tax revenues received from FDIs in the extractive industry. To conduct the study I have used theories explaining the reason behind FDI decisions and the mainstream theories in taxation of extractive industries.

The Albanian state was in the beginning of the 20th century establishing itself as an industrial state. A part of this undertaking was the establishment of a large extractive industry, which was the foundation of the industrial sector. After the events of the 90s the extractive industry regained attention and it is now playing an important role for the development of the Albanian economy. Albania early imposed a royalty of 2 percent in addition to the regular taxation obligations, to attract new investments. This has since then been changed to a new level of 4-10 percent depending on the sector. However, both output and investments remained at a seemingly low level until recent years where there has been a boom in investments, output, research and development activities.

Keywords: Albania, extractive industry, mining, royalty, FDI, fiscal policy
## Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>AKBN</td>
<td>National Agency of Natural Resources</td>
</tr>
<tr>
<td>EITI</td>
<td>Extractive Industries Transparency Initiative</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>INSTAT</td>
<td>Institute of Statistics</td>
</tr>
<tr>
<td>MNC</td>
<td>Multi National Corporation</td>
</tr>
<tr>
<td>NATO</td>
<td>North Atlantic Treaty Organization</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
</tr>
<tr>
<td>UN</td>
<td>United Nations</td>
</tr>
<tr>
<td>USD</td>
<td>United States Dollar</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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1. Introduction

1.1 Background

The access to natural resources has not always been a blessing, where the investments have been desirable but the investment outcomes have often not contributed to overall growth and wealth. In recent years the extractive sector has regained attention due to the increased world market prices and the demand for input. Due to the increased demands a certain attention is dedicated to the taxation policies of the extractive sector.

Albania, after a time of communist ruling, privatized its extractive industry. The theory of FDI considers FDIs as being an important vector in providing poor countries with new capital. But FDIs in extractive industry has been considered more of a curse rather than a blessing. This is because of the risks of corruption and the lack of returns to society. In Albania the state owned companies run inefficiently and the state reached a level where the collapse was inevitable in 1990. One of the consequences was the introduction of imposed budgetary restrictions on state owned companies. As a result many of them were forced to close down or put on stand-by until they were privatized. The Albanian extractive industry has in recent years been exhibiting increased production and increased exports. Export of minerals, construction materials, metals, fuels and electricity, which in 2009 amounted to 32 percent of total exports, comprised only ten percent in 1999.

The extractive industry is believed to belong to the citizens of that country but also to be a non-renewable sector. It is thereby important that the fiscal policy is accurately designed to maximize the impact on the economy.

The Albanian government has introduced fiscal rules for the extractive industry consisting of a tax royalty of 4-10 percent and a profit tax of 10 percent. In addition to this all products are imposed with a VAT of 20 percent. The Albanian fiscal system has also exempted import or export duties, hence simplifying trade with natural resources.

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1 To read more see (Fidan Bytyqi, 2010-04).
2 (Gros & Steinherr, 2004), p. 79
3 (Moran, 2006)
4 INSTAT
5 See table 1
6 (Sokol Mati), Minerals and mining activity, slide 9
1.2 Aim

The aim with this paper is to study the policies and measures adopted in order to attract FDIs to the extractive industry and to maximize their effects on the Albanian economy. Emphasis is put on the design of the tax system and the allocation of tax revenues received from extractive industry.

The topics that will be discussed are:

1. The evolution of the Albanian extractive industry, from state ownership to privatization.
2. The design of fiscal policy:
   - Taxation measures in Albania, before and now.
   - Policy measures affecting the inflow of FDI.
   - Improvement of taxation policies to optimize the effects on the Albanian economy.
3. Revenue allocation to compensate for the extraction of non-renewable resources.

1.3 Disposition

This study is divided into six chapters. Chapter 1 gives a short introduction. Chapter 2 gives a theoretical analysis of the determinants of FDI and FDI in extractive industries. It also highlights a theoretical discussion on fiscal policy measures. Chapter 3 examines how the fiscal system was designed and how it has changed. Chapter 4 examines the development in the Albanian extractive industry. The study continues with chapter 5 which contains a short analysis on how to improve fiscal policy in Albania in order to maximize the effects on the economy. Chapter 6 gives a summary and draws some policy conclusions.
1.4 Method, previous studies and demarcation

This study is of qualitative nature. The theoretical analysis is based upon literature on FDI, FDI in extractive industry and tax policies in extractive industry. Emphasis in the theoretical discussion is put on highlighting both the advantages and the disadvantages of the different strategies. The data is mainly collected from the Albanian statistical authority (INSTAT), the Albanian Customs, the Albanian ministry of Economy, Trade and Energy, and the National Agency of Natural Resources (AKBN).

Previous studies regarding the effectiveness of maintaining a low tax level to attract FDI have shown that a low tax level is not critical for multinational companies investing abroad. Emphasis is instead on factors such as host country political stability, the governments’ attitude towards foreign investors etc. However, studies state that fiscal policy also varies depending on the incentives of the investor. Those investors who were seeking to establish themselves in the domestic market were driven by a low tax level, compared to those investors who were seeking to establish an export-oriented industry. These deliberately export-oriented companies were more driven by tax incentives. There are however motives to implement tax incentives in high competitive industries, such as the garment industry. Due to the high competitiveness of FDIs in such industries, it makes it justifiable to implement tax incentive strategies in order to attain investments.\(^7\)

This study will only consider taxation issues in the extractive industry. The study will further embrace the scope of privatization in the extractive industry. The study will not embrace any deeper analysis of the effects of extractive industry on issues such as backward and forward linkages, corruption, war, civic unrest etc.

The study emphasizes the changes within the mineral sector, hence does not embrace the whole extractive industry.

\(^7\) See study (Morisset & Pirnia, 2000)
2. Determinants of FDIs and taxation options - Theoretical Framework

This chapter is divided into three sections. The aim of the first section is to discuss the determinants of FDI. The second section focuses on FDI in extractive industries. The third section is concerned with tax policies in the extractive sector.

2.1 A general framework of FDI

The term FDI refers to an investment made by a firm abroad, either by acquiring a company in the host country or by establishing a subsidiary in the host country.\(^8\)

FDI has over the years become one of the most important sources of new capital in many countries, especially in developing countries. The extent of capital inflow has been varying from large inflows to lower inflows depending on the expected returns and perceived risks in the region.\(^9\) FDI is viewed as a means to increase growth. The growth literature suggests that the savings rate is positively correlated to higher growth and that the inflow of FDI increases the savings rate. Higher growth levels also contribute to higher tax revenues which the governments can reallocate to new investments. The opponents to the FDI argue that the MNCs investing in developing countries may by entering the host country outrank local companies. They may outrank both existing small competitors but also potential suppliers by, instead of trading with them, import intermediate products by overseas companies. This outcome may lead to a reverse effect, where the intended growth in GDP is not reached. Instead the country sees its economy as becoming more import dependent and its domestic economy failing to provide the demanded input.\(^10\)

FDI may also give rise to externalities transmitted to the local firms through technological spillover. This may for example raise domestic human capital and countries’ capabilities of using modern technology. Knowledge spillovers benefit domestic firms and population. If the authorities expect positive externalities, they might engage in tax competition strategies in order to attract foreign investments. This strategy might nevertheless lead to a situation where the welfare is reduced.\(^11\) Lower taxation means lower tax revenues and lower capabilities for the government to invest in long-term development projects. Opponents to FDI argue that the

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\(^8\) (Markusen & Melvin, 1995), p. 394
\(^9\) (Todaro & Smith, 2006), p. 707
\(^10\) Ibid, p. 711-12
\(^11\) (Hoekman & Kostecki, 2001), p. 420
dominance of MNCs in the host countries inevitably limits spillovers to local firms and the workforce.\textsuperscript{12}

2.2 FDI in extractive industries

\textit{Credibility and risk}

A centerpiece for a government’s ability to attract FDI is the perceived credibility to fulfill commitments. A lack in credibility is associated with the risk of breaking agreed arrangements. This is seen as an obstacle for those countries that have a history of not respecting the initial arrangement but instead imposing new ex post requirements. However foreign investors can reduce this threat by threatening the host countries with withdrawal.\textsuperscript{13}

Raymond Vernon illustrated how the relationship between government and business evolves as the commercial risk changes.\textsuperscript{14} This evolution of risk change leads to an uncertain relationship among the government and the investor. Investors will ex ante demand generous terms when the uncertainty and risk are high. The host countries, on the other hand, will probably agree to those demanded terms, since they are most likely very keen on the investment. After the investment has occurred and the results are displayed the government might in case of a successful turnout break the initial arrangement and renegotiate on new less generous terms.\textsuperscript{15}

A possible lack in credibility can however be dampened by seeking external mechanisms\textsuperscript{16} that show that the government has bound its own and its successors’ hands to enforce the initial agreement.\textsuperscript{17} The use of external mechanisms might however create a moral hazard situation. In case of a breach of contract the external mechanism might offer generous awards to the hurt party and these generous awards might instead serve as incentives not to cooperate, and instead to strive to attain the promise of a gainful compensation.\textsuperscript{18}

\textsuperscript{12} (Todaro & Smith, 2006), p. 712
\textsuperscript{13} (Moran, 2006), p. 77
\textsuperscript{14} See the “obsolescing bargain” model (Moran, 2006, p 78.)
\textsuperscript{15} (Moran, 2006), p.78.
\textsuperscript{16} These external mechanisms might be national and multilateral guarantors. By involving such guarantors it may help maintaining an initial agreement and prevent the authorities from taking actions which would harm the relationship between authority and investor. (Moran, 2006)
\textsuperscript{17} Ibid.
\textsuperscript{18} (Moran, 2006), p. 84-85
Bribery, corruption and transparency

Bribery and corrupt payments are since a long way back in time seen as “natural” instruments of doing business and securing contracts and investment concessions. Literature emphasize however that a fair and competitive bidding ensures that the most promising natural resource project will be run under the best possible terms.\textsuperscript{19}

Since 1999 the OECD has adopted a convention against all sorts of bribery and corrupt payments. \textsuperscript{20} The aim is that countries should start to adopt these recommendations by implementing them in their respective legislations and thus control and prevent bribery and corrupt payments. But the current convention handling bribery and corrupt payments is accused of being too narrow, requiring the member states only to implement the legislation prohibiting direct payment to an official in the country which offers a contract. The problem with bribery and corrupt payments lies in the diversion of production output and public revenues and the possibility for these to end up in public officials’ hands and/or in private hands.\textsuperscript{21} One of the most critical arguments is that it might cause a “resource curse” where such endowments can create a culture of war financing, dictatorships, and fail with what should be the aim, to reach the poorest among the population.\textsuperscript{22} In order to work against these negative phenomena a distinct development program on how to allocate the revenues stemming from the extractive industry can be developed.\textsuperscript{23}

2.3 Fiscal policy in extractive industry

The extractive industry is often taxed differently compared to other sectors due to its special position as a non-renewable source. There are several reasons justifying a fiscal system differing from other sectors. Among those is the long start up time of a new mine before the revenues begin accruing, the high level of capital is needed to start up the extraction capabilities and finally the need for specialized and often customized equipment to be used in the extractive industry. This equipment is often provided only by a small number of

\textsuperscript{19} Ibid. p.94
\textsuperscript{20} Ibid. p.88
\textsuperscript{21} (Otto & Andrews, 2006), p.94
\textsuperscript{22} Ibid. p. 95
multinational companies and must thus be imported. Finally the perceived risk of investing in such a volatile industry must also be considered.  

The high perceived risks associated with the extractive industry are applicable on the host government and the investor. Reasons why both experience risks are because it takes some time before an investor can start extracting resources from a new mine and also because it takes time before he can collect revenues. Another risk is the volatility in prices, since they can fluctuate significantly between a boom and recession. Governments are often very risk averse and they tend to impose taxes in those areas that carry the lower risk, thereby imposing the higher risk on the investor. The investor on the other hand is willing to approve the higher risk only if the host government allows the investor to capture a higher share of the expected profits. One way of transmitting the higher degree of risk to the investor is by imposing taxes based on the quantity of extracted resources. This would entitle the investor to pay a certain amount for every unit of extracted resource to the government and also in times where prices are depressed and the investor’s revenues are low. Conversely a corporate tax or profit tax divides the risk more equally between the investor and the host government.

Another important issue regarding risk is the perceived risk of taxation stability. This kind of risk is of utmost importance for investments inflow into the host country. Investors often seek countries advocating tax stability, but this might be doubtful since one willing government might be succeeded by a reluctant government and the taxes may therefore change. This is also what makes tax agreements among host government and investors hard to maintain. The higher the risk and the uncertainty that the tax rate will change, the higher will the required expected rate of revenue be demanded by the investor. The increased requirements would be uttered by a demanded change of the existing taxation level, thus leading to tax depletion in order to create further incentives to attract investments.

**Taxation options of the extractive sector**

Governments can choose between various types of fiscal instruments when taxing the extractive industry. They can be divided into two main groups (1) *in rem* or (2) *in personam* taxes.

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24 Ibid, p. 16  
26 Otto & Andrews, 2006, chapter 2  
In rem taxes are charged based upon the specific extracted deposits and/or on the inputs used to extract the resources. The in rem taxes rarely include any form of profitability. The purpose with an in rem tax is that it provides the government with annual relatively stable tax revenues. Nevertheless, countries where the exports of primary products (from the extractive industry) constitute a larger share of total exports might be more sensitive to price fluctuations and also put more emphasis on in rem taxes. A special kind of taxes based on the quantity of resources extracted is often introduced, but these kinds are often accused by economists of inducing inefficiencies in production decisions. One option for the government to avert the high price volatility and thereby a sudden fall in taxation revenues is by introducing dedicated revenue stabilization funds where years with high prices contribute to maintaining a pace of revenues even when the country experiences a year with lower prices. This is the case especially in countries that have a large share of primary product exports compared to aggregate exports. Conversely in personam taxes embrace taxes based on net revenues, revenues minus costs. These kinds of taxes are such as income tax, progressive or additional profits tax, withholding tax on remitted dividends and royalty based on profit or income.28 This kind of taxation relies however heavily on the importance of a well established tax administration, hence the ability of the government to have a clear and reliable procedure on tax declaration and collection. Further, countries that aim to attract investors in the extracting sector might use the profit- or income tax– based strategy as a tax incentive. Such an approach imposes a tax based on the investor’s ability to pay. It can be argued that taxes based on the profitability are less distortionary and less inefficient than taxes imposed on quantities of resources extracted.29

**Economic rents:**

The government has a specific interest in taxing those sectors where the economic rent is positive, thus implying that the economic rent is taxable without contributing to a change in choice whether to conduct that specific activity. More intuitively the economic rent is the price charged for a commodity compared to its opportunity cost, the price one would at least want to charge in case of supplying any amount of that good. That difference is the economic rent, the part possible to tax without changing the choice whether to continue activity or not.30

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28 Ibid. p. 30-31  
29 Ibid. p. 38  
One theory of the economic rents is the Ricardian rents. The Ricardian rents theory would suggest that different deposits of natural resources vary in quality and thus also in yield. Where extraction is possible only by conducting easy measures, the outcome is of high quality and/or the transports can be made fast, by e.g. sea transport, the economic rent is higher. This implies that there are deposits (minerals, oil, etc.) that have a lower production cost, higher quality and thereby the extractive industry can be ranked by production cost. Taxing economic rent is from an economic point of view more justifiable, among all because it is fairer since the economic rent is a payment for which the recipe does not have to contribute anything.\textsuperscript{31}

One of the implications by taxing economic rents is that the government might distort incentives for further exploration. Researchers, innovators and entrepreneurs are driven by the economic rents, hence gaining additional revenue due to new inventions. The immediate gain from taxing is that government revenues increase in the short run, but the distortion may decrease incentives for further exploration and the government might have to subsidize the market in order to restore investments in research and new explorations.\textsuperscript{32} The result is that the short run effect of increased tax revenues, in the long run becomes negative for the economy overall.

\textsuperscript{31} (Otto & Andrews, 2006), p. 21
\textsuperscript{32} Ibid, p. 26
3. Fiscal policy – extractive sector

The taxation approach toward the extractive sector is in many cases sensitive, especially due to its property as a non-renewable sector. It is further a sector containing resources which belong to the citizens. Caution needs to made on how the revenues are allocated, emphasizing transparency. This chapter will discuss the current fiscal system in Albania and the advantages and disadvantages of the system.

3.1 Fiscal policy in Albania

Overall taxation

The Albanian state had prior to the events in the 1990s a monopoly on the extractive industry, implying that there was no external party interfering in this economic activity.\(^{33}\) However, after the events of the 1990s the fiscal system changed fundamentally in Albania, so as to become more adapted to a market economy. In 1994 the Albanian government introduced a new legislation which allowed the extraction of natural resources based on a distribution of licenses, allowing simultaneously a controlled extraction.\(^{34}\)

The current implemented mineral strategy emphasizes further that priority is ought to be given also to the transfer of knowledge to the poorer layers of the population, especially in the rural areas.\(^{35}\) This remains however as an ambition whereas a concrete program of how to facilitate this endeavor does not exist.

The Albanian government defines mining as “every activity aiming to exploration, discovery, processing, exploitation, closure, preservation and rehabilitation of the mining environment” (Ligj Për Sektorin Minerar Në Republiken E Shqipërisë, 2010). The rights to extract are granted through the mining permission, hence distributed to those interested in extracting those resources of specific interest to the government of Albania. Both domestic and foreign investors are allowed to express their interest in competing for the grants to extract. The grants are given on a three year basis for discovery and research, which could be extended with an additional year. However, there are several requirements that investors need to fulfill,

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\(^{33}\) (Mati & Bakallbashi, 2006) et al. p. 8  
\(^{34}\) Ibid, p. 10  
\(^{35}\) See also (Mati & Bakallbashi, 2006)
such as the amounted investment level and a minimum extraction level has to be achieved
(imposed by government). Once attained, the permission to extract is granted for 25 years,
with a possible extension of ten years.\textsuperscript{36} In addition to the mining law registered companies
are also obliged to comply with existing fiscal policies, which embrace a wide range of duties.

\textbf{Table 1. Fiscal system and incentives in Albania – concerning extractive industry}

<table>
<thead>
<tr>
<th>Taxes and incentives</th>
<th>Tax rate</th>
<th>Further information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit Tax</td>
<td>10 %</td>
<td></td>
</tr>
<tr>
<td>Personal income tax</td>
<td>10 %</td>
<td></td>
</tr>
<tr>
<td>VAT</td>
<td>20 %</td>
<td></td>
</tr>
<tr>
<td>Corporate tax rate</td>
<td>10 %</td>
<td>Capital gains tax rate, branch office tax rate, withholding tax, dividends, interest.</td>
</tr>
<tr>
<td>Royalty</td>
<td>4-10 %</td>
<td>Based on total revenues after the saleable product. Different minerals are exposed to different levels of royalty.</td>
</tr>
<tr>
<td>Deprecation ruling</td>
<td></td>
<td>Varies between 5-25 % depending on category of assets (durability).</td>
</tr>
<tr>
<td>Transfer pricing rules</td>
<td></td>
<td>Regulated by the Commission of Price Transferring in the General Tax Department. Acts in compliance with OECD instructions.</td>
</tr>
</tbody>
</table>

\textit{Source: Own compilation based on prevailing tax legislation 2011/04}

Table 1 highlights the current taxes imposed on all legal businesses in Albania. The prevailing
taxes are since 2008 an applied flat tax approach where the main taxes are set at a rate of ten percent. The idea of the flat rate approach was to simplify the taxation procedures but also to serve as an incentive for those involved in the informal sector to move their business in the formal sector. An advantage with the flat tax is that incentives to transfer earnings between taxation brackets, i.e. from one tax bracket taxed with a higher rate to another with a lower, are reduced, if not vanished. The reduced tax levels induce however to lower tax revenues if the reductions have not altered any progressive results in terms of increased formal economic activity. Budget deficit, according to IMF statistics on Albania, amounted to -3.7 percent of GDP in 2010\textsuperscript{37}, down from -7.4 percent of GDP in 2009. Albania has since 1997 continuously had budget deficits. With the continuous budget deficit the national debt has increased and today attains some sixty percent debt level of GDP.\textsuperscript{38} An increase of the tax level in Albania would enable a reduction of the gap between revenues and expenditure.

\textsuperscript{36} (Ligj Për Sektorin Minerar Në Republiken E Shqipërisë, 2010), p. 5333, 5337, 5338
\textsuperscript{37} Data available for 2010 are only estimates.
\textsuperscript{38} CIA Factbook on Albania (25/07-2011)
Characteristics of the extractive industry is its dependence on high capital investments, exposed to high sunk costs, whereby the current acknowledged legislation offers an accelerated depreciation policy. This kind of policy enables companies to depreciate their capital goods, hence implying their taxable revenues will be smaller. Accordingly the tax revenues would furthermore be reduced for a seemingly period of time.

The new applied taxes are further in line with regional levels, where many of the countries have implemented a flat tax rate as in Albania. However, there are cases such as Croatia where the taxes are seemingly higher.

Table 2. Tax levels in some Balkan countries and Turkey

<table>
<thead>
<tr>
<th></th>
<th>Personal income tax</th>
<th>VAT</th>
<th>Corporate tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>10</td>
<td>20</td>
<td>10</td>
</tr>
<tr>
<td>Bosnia &amp; Herzegovina</td>
<td>10</td>
<td>17</td>
<td>10</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>10</td>
<td>20</td>
<td>10</td>
</tr>
<tr>
<td>Croatia</td>
<td>12-40</td>
<td>23</td>
<td>20</td>
</tr>
<tr>
<td>Kosova*</td>
<td>5</td>
<td>16</td>
<td>10</td>
</tr>
<tr>
<td>Macedonia FYR</td>
<td>10</td>
<td>18</td>
<td>10</td>
</tr>
<tr>
<td>Montenegro</td>
<td>9</td>
<td>17</td>
<td>9</td>
</tr>
<tr>
<td>Serbia</td>
<td>12</td>
<td>18</td>
<td>10</td>
</tr>
<tr>
<td>Turkey**</td>
<td>15-35</td>
<td>18</td>
<td>20</td>
</tr>
</tbody>
</table>


The applied low tax rates might serve as an incentive for new capital to enter the country. Capital as a highly mobile factor seeks the havens where it is less taxed implying that the taxation on capital is more liable to international competition and a lower taxation would theoretically induce a higher inflow of capital (investments). However, a large number of studies emphasize that tax incentives are less important factors determining investment inflows. The studies emphasize stability, predictability, transparency and infrastructural level as the more important factors to commit new investments.39

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39 See study (Morisset & Pirnia, 2000)
Discussion on the imposed royalty

The unique taxation of the extractive industry is the imposition of a royalty. The royalty distinguishes the taxation of the extractive industry from other industries.

The Albanian government early imposed low royalties of 2 percent so as to give rise to investment incentives. The royalty level of 2 percent was introduced in 1994 and served until 2008, where after the new royalty level, serves until today. Through the change from a flat rate of two percent royalty the government has introduced a classification with a range of 4-10 percent. This implies that the government now has a higher imposed taxation on the extractive industry, whereas it can attain higher revenues. However, by the change it has also enabled the inclusion that different minerals require different time of process of refinement and thereby becomes more costly. By conducting this approach the government is able to attain a higher share of the pure rents, represented by the purity of minerals.

Estimates show that different resources have different shares of value added at the mining stage, with aluminum showing the lowest value added at 9 percent, whereas gold showing 100 percent. For the Albanian case, with a large share of copper production, the estimates show a value added of 77 percent, implying that already after the extraction from the mines the Albanian copper can be gained from, even if it is not further refined. The higher need for processing after extracted from the mine the lower the value added. Comparing the high value added for copper and the royalty level of 4 percent, it seems to be seemingly low, due to its negligible refinement process. Silver and gold as two purer resources that need a shorter time of refinement are both exposed to the highest possible mineral rent of 10 percent.

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40 (Mati & Bakallbashi, 2006)et al. p. 9
41 (Mati P. S., Ministry of Economy, Trade and Energy, 2011)
Table 3. Mineral rent (royalty)

<table>
<thead>
<tr>
<th>Item nr</th>
<th>Commodity</th>
<th>Royalty (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Silver</td>
<td>10%</td>
</tr>
<tr>
<td>2</td>
<td>Gold</td>
<td>10%</td>
</tr>
<tr>
<td>3</td>
<td>Copper</td>
<td>4%</td>
</tr>
<tr>
<td>4</td>
<td>Chrome</td>
<td>4%</td>
</tr>
<tr>
<td>5</td>
<td>Nickel (nickel-silicate)</td>
<td>4%</td>
</tr>
<tr>
<td>6</td>
<td>Iron (iron-nickel)</td>
<td>4%</td>
</tr>
<tr>
<td>7</td>
<td>Lead</td>
<td>6%</td>
</tr>
<tr>
<td>8</td>
<td>Zinc</td>
<td>4%</td>
</tr>
<tr>
<td>9</td>
<td>Coal</td>
<td>4%</td>
</tr>
<tr>
<td>10</td>
<td>Bitumen</td>
<td>4%</td>
</tr>
<tr>
<td>11</td>
<td>Basalts</td>
<td>4%</td>
</tr>
<tr>
<td>12</td>
<td>Construction tiles</td>
<td>10%</td>
</tr>
<tr>
<td>13</td>
<td>Oil and gas</td>
<td>10%</td>
</tr>
</tbody>
</table>

Source: Law nr 1203 – Mineral Rents, approved date 27/08-2008

The current mining legislation also guarantees the local governments, where the resources are extracted a share of 25 percent of total attained tax revenues, so as to contribute to the local welfare. There is however no specifically designed program on how the revenues ought to be used guaranteeing a solid and equal distribution of the revenues. The tax revenues stemming from the extractive industry falls rather to the total budgets of the local governments. The local governments then allocate these revenues depending on their priorities.

The choice of taxing the extractive industry in Albania has a clear advantage on behalf of the government that it imposes a larger risk on the producer than the government itself. This goes in tandem with governments normally being more risk averse. This further implies that the prevailing royalty taxation does not take into account whether the investors are making profits or incurring losses. This implies moreover that the government revenues stemming from the extractive industry exhibit a rather stable inflow of revenues.

The tax revenues are however dependent on the saleable product, i.e. the invoiced prices. By imposing a royalty based on the invoiced prices the government extracts their taxes based on the invoice, implying that other ways of measuring the value of the resources are not used. This might serve as an impediment to the investors, since they are more inclined in investing

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43 [Për Taksat Kombëtare, law nr 9975, article 4, point 4, date 28.7.2008, 2008]
44 (Mati & Bakallbashi, Strategjia e Zhvillimit të Industrise Minerare, 2006)
where they are taxed based on their profits. The imposition of a profit-based royalty would incorporate the profitability, but this would also contribute to minor initial tax revenues for the government, if any at all. Due to the high investments it would take time for the investor to exhibit profits and simultaneously the government to exhibit any tax revenues. This might raise concerns whether the investor is contributing to the welfare or not. By applying the royalty on the invoice prices, the Albania authorities expose themselves to a higher risk, than they would have if they had imposed a royalty based on the produced amount. By extracting royalty on the invoiced price they are more vulnerable to price fluctuations, hence the tax revenues will be dependent on the current price level.

By adopting this approach, in rem taxing, the government is more able to gain tax revenues from the extractive industry in the short-term, compared to the case if they would have imposed in personam taxation. This implies that the imposed in rem taxes as a royalty on mineral sales contribute to a reliable and relatively stable source of immediate revenues to the treasury. Simultaneously the implemented strategy further enables an easy and manageable tax collection, since it does not require any advanced auditing measurements. In rem taxes were introduced in the second chapter as an approach where the imposition of such a tax was well adaptive to regions where the tax collection capabilities were low and the government was heavily reliant on the extractive industry.

The Albanian tax administration has obvious shortcomings and it fails in its capabilities of tax collection. According to the UN based Doing Business report 2011, the country is ranked 149th out of 183 economies regarding the effectiveness of tax administration and implemented tax structure. According to the report the Albanian tax administration exhibits the poorest results among the countries in the region in the amount of time required to prepare and pay taxes, total tax rate and the number of taxes paid per year. Overall the Doing Business report for 2011 places Albania on a 82nd place out of 183 economies worldwide.

Often commonly in developing countries the most efficient and optimal taxation policies, also recommended by taxation theory, are not implemented but rather the possible policy is implemented. This implies that countries rather implement what they believe they can collect rather than establishing better institutions and collecting what would be optimal.

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45 Summary of indicators such as; starting a business, dealing with construction permits, registering property, getting credit, paying taxes etc.

46 (Tanzi & Zee, 2000), p. 4
The Albanian customs are currently mostly benefitting from the VAT, whereas other revenue sources such as customs duties and mineral royalties are a smaller part.

Table 4. Customs revenues in years, 2006-2010, million Leke

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax source</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Customs Duty</td>
<td>13991</td>
<td>9848</td>
<td>8660</td>
<td>7929</td>
<td>7225</td>
</tr>
<tr>
<td></td>
<td>Excise Tax</td>
<td>14418</td>
<td>18969</td>
<td>20895</td>
<td>20217</td>
<td>24829</td>
</tr>
<tr>
<td></td>
<td>VAT</td>
<td>51341</td>
<td>63769</td>
<td>74932</td>
<td>77370</td>
<td>86415</td>
</tr>
<tr>
<td></td>
<td>Mineral Royalty</td>
<td>314</td>
<td>893</td>
<td>2119</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Others</td>
<td>421</td>
<td>476</td>
<td>470</td>
<td>505</td>
<td>636</td>
</tr>
<tr>
<td></td>
<td>Mineral Royalty as</td>
<td>0.30%</td>
<td>0.84%</td>
<td>1.75%</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>percent of total revenues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Albanian Customs

Especially the customs duties are decreasing, as Albania is signing more and more free trade agreements. These will in seemingly short time decrease further. However, the mineral royalties are increasing, since the measure in 2008 the revenues have increased in amount. In 2010 they constituted 1.75 percent of total customs revenues. With the increase in productive capacities the mineral royalty will further contribute to the customs revenues. Nevertheless, compared to other revenue sources the mineral royalties are small and do not resume large shares.

The calculation approach of the royalty tax imposed in Albania by taxing based on total revenues after the saleable product facilitates the tax collection since calculation is based only on the invoice. By taxing on the invoiced prices the government does not consider prevailing world market prices. There can be a divergence between the invoiced prices and the prevailing world market prices, disadvantaging the government due to the possibility of tax evasion. Simultaneously the approach can be undermined by using the possibility to evade taxation. The investors are able to reduce their royalty payments by e.g. undervaluing invoiced prices. This suggests that in the long run the government would be disadvantaged in revenue collection. The ad-valorem, or invoice based, royalty determines the investors’ incentives to extract. By taxing based on the invoice the investor’s variable costs are affected, implying that low marginal mines and low marginal extraction will be omitted from extraction, hence the threshold where extraction becomes viable (profitable) is larger with the government’s in rem taxation and a higher margin is required.
4. Foreign Direct Investments – the extractive industry case

The extractive industries have regained attention after years of lacking in investments. The main contributor is the increased demand for basic resources from the emerging markets, especially the increased demand from the Chinese economy. This has boosted investments in resource rich countries, but also an aggregated increase in production of natural resources overall. This chapter will discuss FDIs in Albania.

4.1 FDI in Albania

After the breakdown of the communism in 1991, Albania gradually introduced a market-oriented economic system. New legislation emerged aiming to encourage private actors to extract natural resources.\(^{47}\) However these private actors had neither sufficient capital nor the technical know-how to develop extractive activity. Further they were too small to benefit from economies of scale.\(^{48}\) Extractive industry production before the 90s was mainly on coal (31.6 percent of total extracted resources), chrome (28.5 percent of total extracted resources), iron-nickel (17.8 percent of total extracted resources), construction materials (9.5 percent of total extracted resources) etc.\(^{49}\) After the 90s there has been a major diversion of production within the extractive industry. With a downfall of production capabilities from existing plants and simultaneously an increase of housing demand.

The increase of housing demand has resulted in an increase of construction materials expansion. Current extractive output mainly stems from the construction materials (47.4 percent).\(^{50}\)

After recommendations by the World Bank the Albanian authorities attempted to privatize the remaining extractive plants. The implemented strategy failed in establishing a productive extractive sector, with a significant down-sizing in production capabilities. The fall in the well-established steel mill plant in Elbasan serves as an eminent example. The plant exhibited in 1989 a production capacity of 750 000 ton of steel, with a production value of USD 140 million. After the privatization to firstly the Italian Darfo S.p.a and shortly after disposed to the Turkish Kurum, the production capacities had declined to 100 000 ton.\(^{51}\)

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\(^{47}\) (Mati & Bakallbashi, 2006) et al., p. 7
\(^{48}\) (Document of the World Bank, 2009), p. 58
\(^{49}\) (Mati S., Opportunities for investments in extractive industries of Albania, 2011/05), slide 27
\(^{50}\) Ibid, slide 28
\(^{51}\) (Document of the World Bank, 2009), p. 58
production is today only ten percent of its current plant capabilities.\textsuperscript{52} Currently there are four concessions besides the distributed mining rights, two in chrome industry, one in copper and one in bitumen. There have been several occasions where the initial agreements have been redesigned and renegotiated. The recent renegotiation occurred in 2009, where the company Darfo S.p.a did not fulfill the agreed investment level.\textsuperscript{53} Investments have increased in the Albanian extractive industry, with peaks in recent years, see figure 1. This is a well established trend going in line with the overall FDI\textsuperscript{s} in Albania. It is however not until recent years that Albania has seriously begun attracting investments as the country also has begun showing a more long-term stability and the world commodity demand of natural resources has increased. The exposed long-term, but slightly fragile, stability has conveyed a security translated into a smaller perceived risk among investors. This smaller perceived risk also enables more long-term investing and also larger investments.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{Investments_in_mining_million_Leke_1994-2009.png}
\caption{Investments in mining (million Leke), 1994-2009}
\end{figure}

Source: Prof. Sokol Mati, Director at the Ministry of Economy, Trade and Energy

The large sunk-costs in the extractive industry requires high rates of return, which can explain the low investment levels until recently where the possibilities to gain large profits has increased. The increased investments seem instead to be mainly driven by the recent years increase in commodity prices. Figure 2 shows how the most common export commodity prices have evolved from 2005-2009.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{Figure_2.png}
\caption{Figure 2}
\end{figure}

\textsuperscript{52} (Document of the World Bank, 2009), p 59

\textsuperscript{53} Edmond Goskolli, director of AKBN, interview 07/07-2011.
The most startling with the above figure is the increased commodity prices in 2008. With the increased commodity prices and the peak in 2008 there was also a peak in the production level of natural resources. There is however a trend deviation in the exports of mineral outputs. The years of 2008-2009 have experienced a decrease in the amount exported, in comparison to the overall increase of production levels in the country.\footnote{Edmond Goskolli, director of AKBN, interview made 07/07-2011.}

Figure 3 states that the amount of foreign companies aiming toward the Albanian market has been increasing in recent years. This can be seen as a consequence of the increased commodity prices and also together with the increased commodity prices, entrepreneurs’ vigilance of the possibility to make a profitable venture.

An important remark is that most of the companies entering the Albanian mineral sector 2008-2009 engage in discovery and research, comparable to preceding years engagement in extraction. This can further be as a consequence of the increased commodity prices and the urge to discover new deposits.\footnote{Data from Sokol Mati, 08/07-2011} With the increased amount of companies registering in the field of research and discoveries, this suggests that there will be a future increase in the production capacities of the Albanian extractive industry. With the increased amount of foreign investments there will be an increase in capital inflows, which will further expand the capital supply. This will enable the country and its citizens to easier access capital and more favorable borrowing options.
The increased interest in Albanian extractive industry has also implied to increased technological imports. Imports of new machineries, equipment and spare parts have been increasing as the investment level has reached peaks in the 2008-2010 period. There was a close to threefold increase in imports of new machineries and equipment during the period 2000-2008.\(^{56}\) The imports of new machinery and equipment are an important factor to increase the level of extractive capacities, thus increasing productivity. They further contribute to enhancement of knowledge. However, there is some concern with respect to the low amount of extracted resources that remain within the country and that is further being processed.

The amount of chrome production in Albania dedicated for exports is approximately 95 percent.\(^{57}\) This implies that a small share remains within the country and is being processed, contributing to a lower value added. Simultaneously the knowledge spillovers would be larger when further processed. This implies that the knowledge spillovers from the current FDIs and current production in Albanian extractive industry is lower.

Even though there has been an increase in royalty in 2008 from 2 percent to 4-10 percent the trend in companies urging toward the country’s extractive sector has maintained a stable increase. The output level has further also experienced an increase from levels of close to 0.5 million tons in 1994 to the highest peak in 2008 of slightly above 4 million tons.\(^{58}\)

\(^{56}\) INSTAT  
\(^{57}\) Own compilation based on data provided by Sokol Mati and Edmond Goskolli.  
\(^{58}\) Data from Sokol Mati, 08/07-2011
The amount of employees in the extractive industry has decreased since the introduction of
the market oriented economy in early 1990s. The decrease was from slightly over 17000
employees to its lowest point in 2001 with approximately 1400 employees. Since the low
point in 2001 there has been an increase in the number of employees in the extractive sector,
in 2009 amounting approximately 6700 employees.\textsuperscript{59} The increased investments in the
Albanian extractive industry, as well as the increased production levels induce that there will
be increased employment levels also in the coming years.

However, in relation to the latest occasions with strikes in the Bulqiza mine some caution has
to be made in the offers to the employees. The current troubles in the Bulqiza mine, directed
by the foreign investor Albanian Chrome (ACR), with strikes have cancelled the extraction
from the mine. This is further the most important region for the Albanian chrome production.
The discord is in providing essential work environment, work safety and moderate
payments.\textsuperscript{60} The continously interrupted extraction and the unsafe investment and work
environment contribute to an increased risk perception with less revenues accruing to both the
government, investor and the employees.

When accounting for the increased domestic production, the amount of foreign companies
establishing in the Albanian market, the amount of exploitation rights and increased
commodity prices there seem to be little evidence that the increased royalty levels have had
any major effect on the decision whether to invest or not. The level of commodity prices, and
thus profitability, seems to be larger incentive whether or not to invest. This implies that
Albania needs to become an attractive host country even in times when commodity prices are
not on its peak.

\textsuperscript{59} Ibid.
\textsuperscript{60} http://www.botasot.info/def.php?gjuha=0&category=6&id=132606 (accessed 12/08-2011).
Risk perception

In order to increase credibility and transparency, thereby mitigate risk level, Albania has joined the international transparency organization for extractive industries, called EITI (Extractive Industries Transparency Initiative). This will likely contribute to a better reputation of Albania as a recipient country. Extractive industries are often accused of causing inequalities and abusing non-renewable resources by enabling officials to conduct briberies and corrupt activities. By enacting in EITI Albania enables a safer monitoring of the extractive industry in terms of payments to the government, how the revenues are used and what the government offer investors in the extractive industry. This suggests that investments will increase as a result of lower risk perception and the current activity will be more transparent. EITI is however, not an institution that makes certain demands on information but more formally publishes what is received from different authorities.

There are however some fundamental distortions regarding corruptive activities in Albania. The Transparency International has after surveys placed Albania on a 87th place out of 178 nations world wide regarding the perceived levels of public-sector corruption. Albania has since 1999 advanced from the nations with highest perceived corruption to recently being placed as a medium level performer. Albania exhibits poorer performance compared to many of the countries in the Balkan region. This induces higher risk levels for investors, contributing to higher demanded levels of expected return accruing to the companies. The high level of perceived corruption might have discouraged investors to expand to the Albanian extractive industry.

To increase credibility and secure that the terms offered to larger investors comply with good and international practice Albanian authorities often prepare arrangements by receiving support from the World Bank. This is a way of securing both the investor and the government that the underlying arrangement is favorable to both parties. However, there is no safe mechanism that prevents one party to enact in any breach of contract. The morale lies more on reciprocal persecution; if the investor does not enact in line with the arrangement then the government won’t do it either.

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61 Albania adhered to the EITI in 2009, see webpage http://eiti.org/albania (2011-06-15)
62 Edmond Goskolli, interview conducted 7/7-2011.
Albania is aiming to further strengthen its perceived stability by already having joined NATO\textsuperscript{63} and further having the ambition to join the EU. However, its ambitions to join the EU are partly being interrupted by major political concerns among the largest political parties. This political combat often leads the country into deep political problems in which the international community often needs to be incorporated to solve. The results of this can lead to increased risk perceptions, where the investors see Albania as an unsettled host country. A high level of risk perception does not benefit the Albanian authorities. On the contrary, it contributes to a less favored bargaining situation where investors are able to demand higher economic profits.

\textsuperscript{63} Member in 2009, see webpage www.nato.int.
5. Fiscal policy improvement to maximize effects

Albania has implemented a royalty level of 4-10 percent. However, the investments have not been large until recent increases in commodity prices. Today extractive activity is increasing, leading to larger output and expanded job opportunities. The increase in extractive activity has nevertheless led to increased exports of the extracted resources, implying that the internal demand is lower. This chapter will discuss possible fiscal policy improvements, so as to maximize the effects on the Albanian economy. That is to maximize effects in terms of increased incentives to invest, increased tax revenues and achieve a more equal allocation of revenues stemming from the extractive industry.

Short discussion on the current fiscal system

The applied strategy in 1994 with a royalty level of 2 percent might have been investment inhibitory, when regarding the minor investments and the low development of the Albanian extractive industry until the commodity prices boosted in 2008. When commodity prices are low, there can be reluctance in investment and hence extracting resources due to the low profitability. With current contractual requirement (tax legislation) the investor is obliged to extract a certain amount otherwise the extraction grant might be lost. This kind of approach serves the government more, by applying a higher risk on the investor. The government in this case ensures an inflow of tax revenues. Hence the investor has to pay the royalty regardless if the venture is profitable or not. However, there is a risk associated with this approach. The risk being that extraction drops when commodity prices are low, because there are no margins to both make enough profits and pay royalties. Further, investors might have been more reluctant in establishing production in countries where they cannot ensure taxation based on prevailing market situation, taxing whether profits are made or not. This might be one of the explanations why the investments in the Albanian extractive industry did not take off until the increase in commodity prices from 2000 onward. This suggests that the price boom served as an investment incentive. Also the easement of the taxation system with the introduction of the flat rate system might have contributed to the increase of extractive industry activity.

Improving fiscal policy

There are several issues emerging when considering what would be the optimal way of taxing Albanian extractive industry. In accordance to the already established theoretical framework it would be favorable to tax depending on the kind of resource, the severity of extraction,
transportation costs etc. However, a well established tax collecting system, especially the countries’ ability to collect data and information regarding the production has to be strong. This applies especially when it comes to the investors’ under-reporting of revenues and over-statement of costs. These kinds of measures require skilled administrators.

The current implemented system, in rem taxation based on the invoiced prices, fails in encountering the price volatility of the commodities. It also fails in maintaining a fair share of the economic rents accruing to the government. Instead the share accruing to the government when commodity prices increase falls, benefiting the investor.

There is due to the falling share of the economic rents a clear divergence between the progressive and regressive taxation, as Land (2007) expresses. In times when the world market prices on resources are high the share accruing to the government falls, hence implying that we have a regressive transfer of a robust fiscal policy.\footnote{\textcite{Land, 2007}}

The Albanian fiscal policy fails in embracing profitability accruing from the volatility in prices. This contributes to lower tax revenues, simultaneously as the investors gain when commodity prices increase. The aim should therefore be to impose a system which is not rigid to world market changes, but one that is more adaptive to the prevailing circumstances. A clear improvement would thus be to implement a fiscal policy which would encounter for the price volatility and the increase in profitability, obviously by a progressive in personam taxation. By applying a progressive transfer the government would be receiving a fairer share of the mineral rents.

The in personam taxation would as discussed in earlier chapters enable a taxation based on the profitability of the investors and not the amount extracted. It is however important to acknowledge the facts that the tax policies have recently been changed and in order for the authorities to reflect credibility it is not recommended making continuous changes rather one should maintain the prevailing taxation levels. Due to “obsolete bargaining” discussed in chapter two the government should not in the short run enact in further ex post tax extensions with higher taxation as soon as the government senses higher commodity prices. This would probably lead to higher short-term tax revenues but could become inhibitory to future investments and a loss in credibility would be self-fulfilling.

\footnote{\textcite{Land, 2007}}
There are indicators that the authorities are planning to make changes in the flat tax base of 10 percent, so as to increase tax revenues.\textsuperscript{65} This can become an impediment in the quest to become predictable and by this also gain credibility. These kinds of actions can result in lost investments and also lead to the inflow of mainly short-term investments.

The progressive taxation would enable a predictable and credible taxation structure, due to its advantage of being predictable in the sense of initially being part of the arrangements. By conducting this strategy the authorities would not need to enact in any ex post unilateral redesigns of the initial arrangement. The current regressive system does not secure an in tandem increase of tax revenues as the commodity prices increase and the investor’s profits increase. By applying a progressive taxation as a part of the initial arrangement, the need for renegotiations decreases when commodity prices increase. Simultaneously as the progressive taxation would enable a more equitable system of profit sharing, also when profitability increases. The system is thereby predictable. The government however needs to abort the current royalty system in order to implement a progressive taxation. This would imply a loss in tax revenues in the short-run and could be an impediment for the authorities to implement. With the royalty being easier to administer it might become more lucrative to apply such an approach.

From the early 1990s until after 2000 there was not any wide-spread attention on the mineral sector, mainly due to low commodity prices. There was an urge during this period to attract investments into this sector, mostly achieved by competing in tax levels. This induced countries to lower taxes. Simultaneously with the low commodity prices only the largest world deposits were viable enough to gain investments and were invested into.\textsuperscript{66}This has been visible also in Albania, where there have not been any large FDI inflows in the extractive industry until recently as the commodity prices have been increasing. The lack of FDI inflows in the extractive sector might partly be seen as a failure of the taxation system. However as the commodity prices have increased also smaller deposits, in comparison to the main ones worldwide, have become more viable and interesting to invest in.

In order to attain investments during periods of low market prices, when the profitability might be more modest, the prevailing tax regime can be inhibitory. This is due to its inability to encounter market prices and profitability but rather impose a tax on extraction. Further,

\textsuperscript{65} http://www.botasot.info/def.php?category=6&id=116454 (accessed 29/04-2011)
current in rem taxes, may be inhibitory to further exploration. The low exploration activities can set a pressure on the eager to further expand FDI also during times when the prevailing market prices are low, and hence offer too favorable contracts. The prevailing mining law 67 allows the government to make arrangements based on the single errand. Thus every investor can be treated differently where the government believes it is of interest. This is further an incentive to improve the tax administration and to enable the collection by implementing in personam taxes.

One disadvantage with the progressive taxation, in personam taxation, is that it might serve as an incentive remover. Since inventors and entrepreneurs are eager to be first in their respective areas so as to attain the economic rents. By implementing a progressive taxation the investors’ incentives would decrease since the purposes of exploring and gaining in economic rents would be reduced. A weighted approach which would encounter for this negative effect is emphasized.68 Further disadvantages are that the short-term tax revenues would be seemingly smaller with the in personam taxation. In compliance with the depreciation rules in Albania this would contribute to small tax revenues in the short to medium-term, until the depreciation period of the inventories is finished. Since tax revenues are a necessity to further development in Albania, an in personam approach in Albania, with seemingly low tax revenues, might serve as an impediment.

As discussed earlier further disadvantages with the in personam taxation is that it becomes harder to monitor all the economic activities. This implies that a risk might enhance related with under reporting of real profits on behalf of the investors. The under reporting of real profits can be achieved through transfer pricing.69 To avert transfer pricing possibilities the government would need to prepare its tax administrators in enhancing auditing skills. Otherwise, by implementing a progressive in personam taxation, without possessing the adequat auditing skills it might lead to losses in tax revenues.

67 See Law nr 10 304, Mining Sector in the Republic of Albania.
69 (Todaro & Smith, 2006), p. 713
Two staged approach

One possible strategy that would maintain the credibility and also become predictable, simultaneously as it would give time for the tax administration to evolve and increase efficiency, is by introducing a short-term (1) and another long-term (2) strategy.

The short-term strategy encounters the prevalence of the current fiscal system with a royalty of 4-10 percent so as to maintain credibility. Simultaneously a program\textsuperscript{70} that would facilitate growth can be implemented. As has been explained a fair distribution of the revenues stemming from the extractive industry would be to make them far reaching. This can be facilitated by investments such as education and specifically in industries that would be complementary to the extractive industry.

In the long-term a change in the tax structure complying with the one discussed in this chapter, the progressive taxation, can be implemented. By conducting this approach the authorities maintain credibility. Albania needs to be able to attract FDIs also when commodity prices are lower. In order to maintain investments at a stable pace the fiscal system needs to acknowledge the profitability of current venture. This implies that a system adaptive to the prevailing world market needs to be implemented.

As a complement to the progressive taxation approach a suitable way to prepare for possible declining commodity prices is a fund that stabilizes the volatility in commodity prices. With progressive taxation, part of the in personam taxation, the government would in times when the commodity prices are lower gain less in terms of tax revenues, since the taxation is based on profitability. A stabilization fund would assist in creating a stable flow of revenues in a volatile industry.

Further extensions

Albania fails in facilitating the revenues accrued from the extractive industry. The current system enables the use of these revenues by including them in the total government budget, without specifying the use of these revenues. A favorable and fair measure that can be implemented is a program which enables a fair use of the collected taxes, with the aim to serve as an investment for the future so as to compensate for the current losses in extracted non-renewable resources. The program can be designed to increase the level of human capital. This would imply investments in education, in both supplying workforce to the developing

\textsuperscript{70} Read next page “Further extensions”
extractive industry but as well in sectors which would create a larger value added to the extracted resources. This would simultaneously create a more diversified economic activity. Albania is currently in a development stage where the internal development is low and the encircling industries demanding extracted resources are low. The extracted resources are thus referred to the external market rather than driven by an internal demand. A specifically designed program aiming to mitigate this narrow industrial base can serve as an economic booster. A share of 20-25 percent of tax revenues stemming from the extractive industry is however dedicated to the local governments where the sources are located. This is seen as a compensation for the extraction. But, nevertheless even this share falls into the total budget of the local government.
6. Conclusions

The purpose of this paper was to study the policies and measures adopted in order to attract FDIs to the extractive industry and to maximize their effects on the Albanian economy. Emphasis was put on fiscal policy and the allocation of tax revenues received from the extractive industry.

The Albanian extractive industry experienced in the 90s a drawback from its initial important role as a growth providing sector. However, in the last years, from 2007 onward, there has been a sharp increase in output and investments. The amounts of resources in Albania are highly interesting, since they are in large quantities and of high quality. It seems that a combination of the large quantities and the favorable world market prices has been the prime motives for the increasing activity. The taxes were initially set at relatively low levels, whereas they have in recent years been increasing as there has been an increased demand for the Albanian resources. The current fiscal system fails however in embracing the increasing commodity prices, where the share of the pure rents mainly falls in the hands of the investors. The Albanian authorities would experience a larger economic activity if they were to implement a more progressive taxation. This would simultaneously ensure that a fairer share of the profits would accrue to the government. There is however a disparity of the current tax administration and its ability to collect taxes and the ability to implement a progressive taxation. This is due to the requirement of a well-developed and structured tax administration. The inefficient performance of the Albanian tax administration should therefore serve as an incentive to improve and thus implement more efficient tax administration and collect capabilities. The improvement would enable the implementation of more optimal tax policies. The increase in industrial production has mainly been on crude resources, where the value added is also seemingly lower. This contributes consequently to lower profits for both the state in terms of revenues but also to the inability to offer a wider spectrum of job opportunities. The prospects and capacity of an increased extraction are positive. Caution must however be taken considering that the increase of extraction might fall to the investors alone. These kinds of actions have caused the ‘resource curse’ where disorder has been followed. A diversification of output would further decrease the reliance on specific products and hence also mitigate the high trade deficit.

Recommendations are that revenues gained from the extractive industry through royalty taxation etc. should be part of a designed program which specifically has the advantage of
being developed to increase human capital and to serve as a booster of the manufacturing industry. This would for Albania imply a further extension of the product portfolio and a reduction of unemployment in Albania, but also make an appreciable contribution to the treasury. The country has a bright prospect in the extraction of chromium, nickel and the prevalent resources of copper are relatively high, thus expanding FDI policies to complementing these extracted resources ought to be prioritized. The Albanian extractive industry was the sector establishing Albania as an industrial nation before the 1990s. Due to its importance and size before the 1990s there exists an engineering know-how and also the industrial legacy can be a gainful advantage. However, establishing a wide-range production economy requires notable resources of energy. The current situation with electricity reductions inhibits full investments in large energy-consuming plants. In tandem with the development of the energy providing plants the government ought to prioritize the imposition of new taxation measures which would maximize the revenues without becoming inhibitory.

Further related studies can be conducted in the field of oil and hydro power in combination with tax policies. Moreover studies relating to how the revenues more specifically can be used to design a program, which would help boosting the manufacturing sector, are recommended. Studies relating the demand of energy to the development of the Albanian extractive industry can also be of value.
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