Foreign Direct Investments and Mergers & Acquisitions in Slovakia

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SUMMARY

The paper gives answer why Slovakia is so attractive for Foreign Direct Investments. There are discussed economics factors in Slovakia and there are compared with economics factors in some another countries.

INTRODUCTION

In Slovakia, an enormous and revolutionary economy - development took place over the last seven years. At the beginning of the nineties, the country seemed to be dependent on the Czech Republic. Meanwhile the capital Bratislava is said to be the most dynamic region of all countries of the CEE region apart from Prague. As a matter of fact Slovakia was disadvantaged at the beginning: In Czechoslovakia a by far larger share of government aid went to the Czech constituent republic. Until 1998 the country was viewed by many with a great deal of caution and the prospect of entry to NATO and the EU was a pipe dream. Today Slovakia is a full member of the EU, NATO, OECD and has been described in the media as being Europe's Best Kept Secret and as a "Crouching Tiger". The current government is a long way down the path of reform and has made the country an extremely attractive place to do business, with some of the lowest tax rates in Europe and a highly skilled and cost-effective work-force.

Sound macroeconomic policy, assertive product, capital and labour market liberalization, and fundamental tax and welfare reform have transformed the Slovak business environment in recent years. Foreign direct investment (FDI) has responded particularly well, becoming the prime engine of capacity and productivity growth, and helping to put the economy on a strong and well balanced growth path.

Investing in any new location is always a challenge and even the most experienced business people need support and information, together with total confidence in their professional advisers. The main focus of the industrial development was primarily in the energy and commodity intensive areas like metallurgy and defense industry. The country was said to be the armorer of the Warsaw Pact. Approximately 60 percent of companies summarized under the title of engineering were part of the defense industry.

The share of the servicing industry rose from 33 percent in 1991 to 58,9 percent in 1999 on the back of newly founded small enterprises. The rate declined again at the beginning of 2003 to 32,8 percent. Meanwhile the privately run sector earns almost 90 percent of the Slovakian GDP.

As a result of the slow privatization policy and the limited flow of foreign capital delayed the restructuring emphasis. The input of resources and especially the input of energy of the industrial sector is still substantially higher than the EU average. The restructuring is not finished yet. Although the influx of foreign direct investment (FDI) into Slovakia is lower than its neighbouring countries, the results show that foreign investors have discovered the Slovak Republic and consider this country to be one of the best investment places in Europe.

In 2003 PSA Peugeot Citroen started construction of a plant near Trnava and in 2004 the South Korean car maker Hyundai decided to invest € 700m and the German company Getrag Ford announced the construction of a € 350m transmission plant in the Slovak Republic. Tax reform and cheap labour were cited as the main reasons behind this decision.

The driving force behind such a sharp increase in FDI was primarily the investor friendly policies adopted by the current government of the Slovak Republic. Many instruments and laws have been introduced within the last three years to help foreign investors in Slovakia.

As at 31 December, 2003 the industrial sector accounted for over 37.9 percent of FDI, of which the majority was directed towards automotive components, consumer electronics and precision engineering. Other important sectors were banking and insurance (22,7%), transport, warehousing and communications (10.1%), wholesale and retail trade (11.5%) and production and distribution of electricity, gas and water (12,0%). FDI inflows have been heavily skewed towards the western regions of the country, which are geographically closer to the rest of the EU, Slovakia's main source of FDI. Bratislava alone absorbed 69.7% of total FDI up to the end of December 2003. The industrial region of Kosice, which ranked second, only accounted for 10.1% of the total FDI inflow. Privatization of the energy utilities (which are based in Bratislava) only widened these regional disparities.

WHY BECAME SLOVAKIA SO ATTRACTIVE FOR FOREIGN DIRECT INVESTMENTS?

In daily business director of "CONIS Consulting Industrie Service GmbH", (www.conis.at), an Austrian firm with its business - focus on the Mergers & Acquisition field following arguments for Slovakia's attractiveness for FDI and/or M&A's are to be highlighted:

1. Politically stable.
2. EU Member State, EMU membership onwards 2009.
3. 19% investor – friendly flat tax regime.
4. No taxes on corporate dividends.
5. Investment incentive packages (subject to EU rules).
6. Rated by World Bank as one of the 20 most investor friendly countries in the world.
7. Almost the whole of the EU within a radius of 2000 km.
8. 220 million potential customers within a radius of 1000 km.
9. Gateway to the Balkans and another 440m inhabitants.
10. Highly skilled and flexible workforce.
11. Low cost of labour.
12. Liberal labour code.
13. Low cost of living.
14. Wide selection of land available for purchase.
15. Excellent telecommunications infrastructure.
16. Highway network growing steadily.
17. Excellent rail services for both passengers and freight.
18. Trans European water transportation via the River Danube.
19. Direct international air services between Bratislava and many European cities including Brussels, London, Milan, Munich, Paris, Prague, Rome, Warsaw and Zurich.
20. A country of great natural beauty.

The current government has embarked on a future – orientated and challenging program of major economic reforms including to:

- ➢ Decrease inflation and government spending to below 3% of GDP in order to meet the Maastricht criteria. Slovakia aims to adopt the Euro in 2009.
- ➢ Finish reforms of healthcare and education sectors as well as of public administration systems to reduce financial burden on fiscal spending.
- ➢ Improve infrastructure and the business environment to attract high value-added Investments and decrease unemployment.
- ➢ Maintain the level of growth of GDP at a constant 5% target (constant prices).

Foreign Direct Investment (FDI)

Slovakia's growing economy has also led to healthy growth in foreign direct Investment (FDI), which reached a year-on-year increase in 2000 – the highest increase among all EU candidate countries.

Indicator	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*
FDI (SKK mil)	47 109	58 107	78 568	96 038	177 141	234 396	313 118	346 121
FDI (USD mil)	1 477	1 671	2 128	2 272	3 738	4 836	7 821	10 514

Source: The statistical yearbook of the Slovak Republic; The National Bank of Slovakia

As in 2003 and 2004 the top investor country for private sector was Austria, followed be Czech Republic and the Netherlands.

Investment Incentives

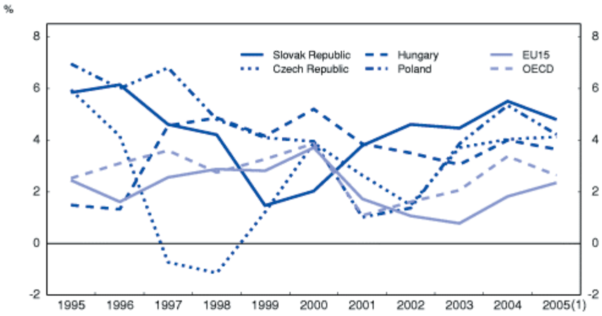
The Slovak Government provides a series of attractive incentives for both foreign and domestic investors. These include an attractive tax credit system, together with cash grants for newly created jobs and for training. Legislation relevant to these incentives includes the Act on State Aid, the Act on Investment Incentives, the Income Tax Act and the Employment Act.

Slovak Investment and Trade Development Agency (SARIO) is the leading implementation agency for FDI support and is a direct competitor to agencies in Hungary, the Czech Republic and Poland. SARIO's activities leading up to an influx of investments will have to be challenged into the following four venues – image making, Investment generation, support for investors and Investment climate improvement. The strategy for FDI is to encourage existing investors to realize their projects with a high level of added value and earn the highest possible Investments volumes with high added value on the part of investor.

ECONOMIC KEY - FACTORS AND PERSPECTIVES ATTRACTING SLOVAKIA FOR FDI

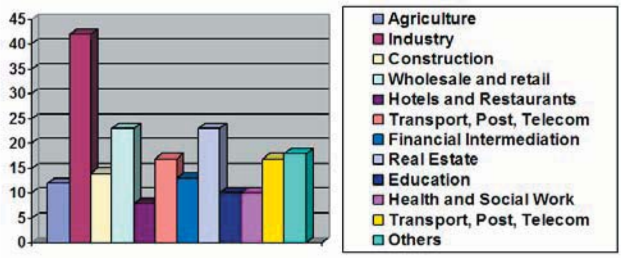
Economic Growth

Slovakia's gross domestic product (GDP) has been growing steadily, reaching 3.3 per cent in 2001 and projected at 3.6 per cent in 2002. Growing domestic demand has been driving the rise, aided by gains in fixed Investment. In 2004 real GDP has reached US$ 41.1 billion, the GDP growth has reached 5.5% in 2004 and is forecast to rise to 5.8% in 2005. The Nominal GDP per capita has reached US$ 7.600.



Source: Economic Survey of the Slovak Republic 2005

Figure 1. Slovakia's reforms have contributed to impressive GDP growth rates



Data - Source: Slovak Statistical Office

Figure 2. Gross Domestic Products by economic activities in 2004

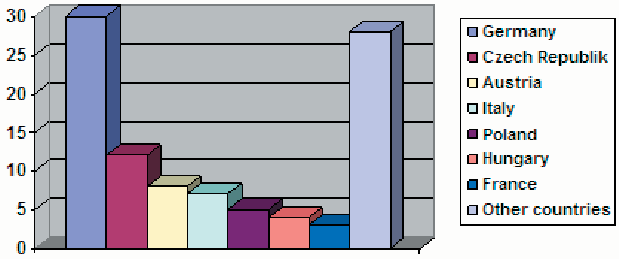
Export

Slovakia's export earnings continue to grow, particularly to countries in the European Union. In 2001, exports were up 11.3 per cent, year-on-year, 61.7 per cent of which went to the EU. Sectors driving Slovak exports include mechanical engineering, chemicals, pharmaceuticals, rubber and metallurgy.

Besides exports, Slovakia has been increasing its share of imports – by 21 per cent year-on-year in 2001. A big part of this surge was from the import of machinery, electrical appliances and motor vehicles, excluding passenger cars.

Structure of Foreign Trade	*2001*	*2002*	*2003*	*2004 (2.Qu)*
Import	713,8	747,9	826,7	691,1
Export	610,6	652,0	803,2	686,3
Ballance	-95,9	-103,2	-23,4	4,8

Source: The statistical yearbook of the Slovak Republic; The National Bank of Slovakia



Data - Source: The statistical yearbook of the Slovak Republic; The National Bank of Slovakia

Figure 3. Percentage of Slovak exports

The Tax Credit System

The tax credit incentive has been fully accepted by the European Union and as a result, Slovakia is currently the only country in the Visegrad - Four that can offer certainty with regard to its tax based incentive package. The Slovak tax credit system provides a benefit of up to 50 per cent of the qualifying expenditure on Investment outside the Bratislava region. In the Bratislava region the benefit can amount to up to 20 per cent of the qualifying expenditure. These tax credits apply for a period of up to 10 years, subject to these regional state aid limits.

Tax Reform

Great international attention to Slovakia's Tax Reform of 2004 has been paid and as a result, the Tax Reform became the most attractive factor for FDI in Slovakia. The Introduction of a single 19-percent VAT rate has increased prices of all the goods and services. The revision to the VAT law has taken effect in July 2003 due to the introduction of taxation of advance invoices, which would raise state-budget revenues already this year. According to the Finance Ministry, the revision should simplify the mechanism of VAT implementation and boost state-budget revenues from indirect taxes. The introduction of a single VAT rate ease the administrative burden of taxpayers and tax administrators and prevent speculative tricks enabled by the earlier existence of two VAT rates. According to a report about the macroeconomic impact of tax reform elaborated by the Finance Ministry, household consumption has increased by only 1.8 - 2.2 percentage points compared to the originally expected 2.9 percent.

Further to this, the drop in aggregate demand should reduce imports. The Finance Ministry expected that an increase in Investments by 0.3 percentage points to 6.1 percent should partially compensate for the decrease in household consumption. Thus the tax reform has leaved economic growth untouched, while the foreign trade balance has improved. In the medium and long term, reduced income taxes should bolster Investment activities, attract foreign investors to Slovakia, and strengthen productivity of Slovakia's economy. This should have a positive impact on economic growth and rising employment at least until end of the decade.

Indirect Taxes

The Slovak VAT law is valid since 1 May 2004 and is harmonised with the EU Sixth Directive, which is the basic directive for VAT in the EU. The standard rate of value added tax (VAT) in Slovakia is 19%. There is no reduced VAT rate.
The Slovak VAT law obliges recipients (taxable persons) of certain taxable supplies from other EU-member states to self-tax (reverse charge) Slovak VAT on the received taxable supplies. Special VAT rules apply to the acquisition of new means of transport from other EU-member states. Besides VAT returns, a Slovak VAT payer must submit the following reports:

- ➢ quarterly EC Sales Lists, if he is supplying goods to other EU countries; and
- ➢ Intrastat reports each month, if his acquisitions of goods from other EU countries or supplies of goods to other EU countries exceed certain thresholds.

Excise Taxes

The new Excise Taxes Acts are effective since 1 May 2004 and are fully harmonized with EU legislation. Excise taxes are imposed on categories of goods produced in, delivered to, or imported to the Slovak Republic such as: Mineral oil, Spirits, Beer, Wine, Tobacco products, etc..
The tax rate, tax period, and payment of excise tax depend on the exact nature and quantity of the goods. Excise tax is included in the tax base for calculating VAT. Entities that want to produce, receive or send goods subject to excise tax under a tax-exempt regime (suspension arrangement) must register at the local Customs Office as a warehouse or an authorised receiver. The delivery of goods to Slovakia under a tax-exempt regime must be carried out with accompanying administrative documents. If the company or individual uses tax-exempt goods, it has to apply for a consumption card, on which the purpose for using the goods is recorded.

Cigarettes and alcohol in consumer packaging produced in, or delivered to, the Slovak Republic must be marked with a certified stamp. Slovakia applied for a transitional period for the imposition of excise tax on electrical energy, coal, and natural gas.

Income Taxes

The Slovak income tax law valid as of 1 January 2004 was partially harmonised with the EU legislation and is now fully harmonised since 1 January 2005.

Personal Income Tax

The Slovak personal income tax rate is 19%. The following incomes are subject to personal income tax: employment income; income from business activities, other self employment, and rent; income from capital property; and other income. Slovak tax residents are taxed in Slovakia on their worldwide income. Slovak tax residents include individuals with permanent Slovak residence, as well as those who stay in Slovakia for 183 days or more in a calendar year. Non-residents are subject to Slovak personal tax on their Slovak-source income only.

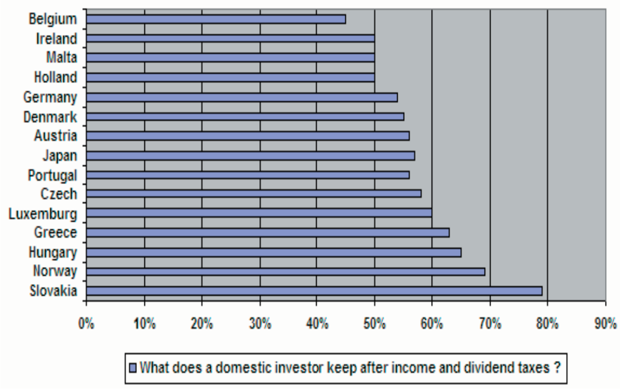
Corporate Income Tax

Slovakia has the best tax regime in the region for investors, there is no Tax on Dividends. The corporate tax rate in Slovakia is 19%. The following entities are subject to Slovak corporate income tax: A company that is treated as a Slovak tax resident (if it is incorporated, or has its place of management in Slovakia). Resident companies are subject to Slovak tax on their worldwide income, subject to double taxation treaty relief. The provisions of double taxation treaties may take precedence over the Income Taxes Act. Slovak tax-non residents are generally taxed on Slovak-source income only, subject to Double Taxation Treaty relief. Since 2004, it is possible for a Slovak entity to have a taxable period different from the calendar year. Distribution of 2004 and onwards profits are not subject to Slovak taxation.

Table 2. Corporate Taxation (in %)

	Corporate ITR (2004)	*Effective ITR (2006)*	*Tax on Dividends*
Slovakia	19.0	16.8	00.0
Hungary	16.0	14.0	20.0
Poland	19.0	17.5	20.0
Czech Republic	28.0	17.1	15.0
Germany	26.5	36.0	23.5

Data Source: EU-statistics (www.EUstatistics.net), modified by the authors

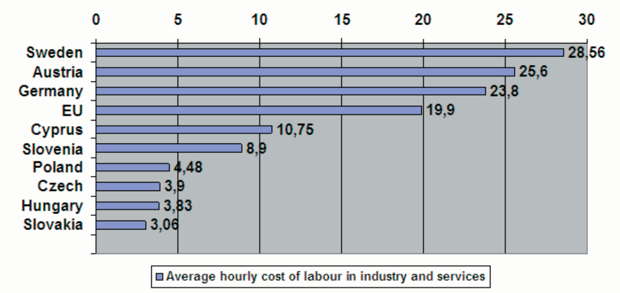


Data Source: EU-statistics (www.EUstatistics.net), modified by the authors

Figure 3. A comparison with other countries shows the attractiveness of the Tax - Regime ...

Low Labour Cost

At identical productivity rate, labour in Slovakia is ca. 30% cheaper than in Czech Republic, Hungary and Poland and approx. 6.5 times lower than in much of Western Europe.



Data Source: EU-statistics (www.EUstatistics.net), modified by the authors

Figure 4. Average hourly cost of labour in industry and services

Average Monthly wages	*2001*	*2002*	*2003*	*2004*
In SKK	12 365	13 511	14 365	15 472

Source: Slovak Ministry of Labour, Family and Social Affairs

Social Benefits

Employers are required to contribute a minimum of 0.6% of gross monthly salary to a separate company bank account on behalf of their employees. The purposes for which payments from the Social Fund can be made are explicitly specified by law, e.g.; employees' rest and recuperation, subsidy on commuting etc. Both the employer and the employee are required to contribute to the social and health security systems. According to the Slovak social health care security system, an individual pays contributions to the social security and health care system. The rate is determined by Slovak domestic law, the rate in the table is effective since July 1, 2005), from 1. January 2007, this amount shall vary from 0.3% to 2.1% according to endanger to employee's health, current rates are shown in the table below:

Table 3.Contributions and social fund

Insurances and funds	*Min. comp. base in SKK*	*Max. comp. base in SKK*	*Employee in %*	*Employer in %*
Retirement insurance	6,500	43,095	4.0	14.0
Disability insurance	6,500	43,095	3.0	3.0
Sick leave insurance	6,500	21,548	1.4	1.4
Unemployment insurance	6,500	43,095	1.0	1.0
Contribution into Reserve fund SIC	6,500	43,095	0.0	4.75
Guaranty insurance	6,500	43,095	0.0	0.25
Injury insurance	No limit	No limit	0.0	0.8
Health care insurance	6,500	43,095	4.0	10.0
TOTAL in %			*13.4*	*35.2*

Source: Slovak Ministry of Labour, Family and Social Affairs

Table 4. Sick leave

Period of Absence	*Paid by Employer*	*Paid by Social Insurance*
Days 1 to 3	25% of salary	-
Days 4 to 10	55% of salary	-
Day 11 onwards	-	55% of salary

Source: Ministry of Labour, Family and Social Affairs

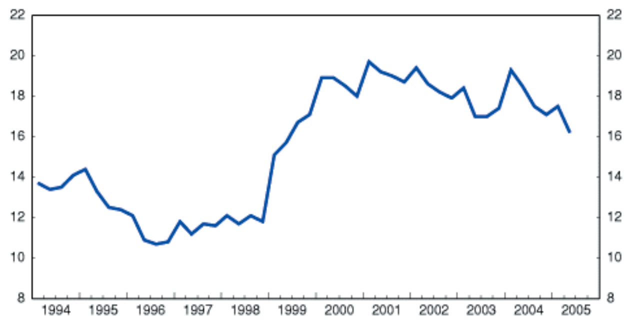
Labour Market

The key law governing employment is the Labour Code. Under this code, all employers in the Slovak Republic are obliged to conclude written employment contracts with their employees. The employment contract usually covers matters such as the name of positions salary and the length of the trial period (up to three months). Employment contracts can be for limited or unlimited periods. The maximum working time in one week is 40 hours. Employees may not work more than 8 hours overtime per week, with maximum of 150 hours per annum. Remuneration for overtime may consist of granting additional time off or the payment of additional wages. The minimum annual holiday is four weeks. Any employee who has worked for 15 years or more is entitled to five-weeks annual holiday. The labour code also specifies the time of maternity leave, which is 28 weeks.

Table 5. Unemployment

Unemployment rate	*2001*	*2002*	*2003*	*2004 (2. Quarter)*
	19,2	19,4	17,4	18,5

Source: Slovak Statistical Office



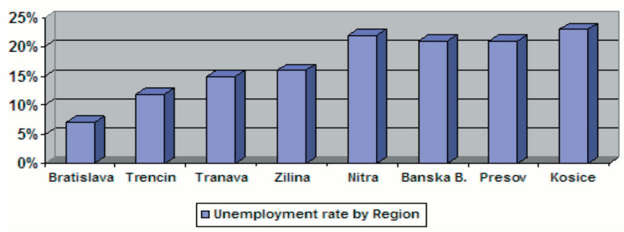
Source: Slovak Statistical Office

Figure 5. Unemployment in Slovakia as per cent of labour force

Unemployment has begun to fall, but remains still very high

Unemployment Rate by Region

Slovakia is a country with enormous regional differences. In the Bratislava region the average income is more than double of Slovakian average salary. Where as the unemployment rate in the capital is below 5%, it is more than 30% in the structurally weak areas in the Carpathians in the east of the country.



Source: Slovak Statistical Office

Investment Stimuli Legislation

Slovakia has specific Investment stimuli legislation which provides for both tax incentives in the form of a tax holiday for up to 10 years and labour subsidies. The latter are connected with the creation of new jobs and to the training of employees.

The general conditions for Investment stimuli under this legislation are:

Establishment of a new plant or modernization or extension of an existing plant to be used for the production of goods or provision of services; Investment of at least SKK 400 million in assets (of which at least SKK 200 million must come from the founders' equity) or SKK 200 million (with SKK 100 million founders equity) when the company is domiciled in a region with an unemployment rate exceeding 10%;

The Investment must be made and relevant activity must commence within three years after the final decision on Investment qualification is issued; At least 80% of the sales of the company are sales from activities stated in the Investment plan; A confirmation of the Slovak Government is required.

It should be stressed that:

- There are many additional detailed provisions and exceptions which need to be taken into account.
- There is no automatic entitlement to (tax) incentives or other grants under this legislation in the Slovak Republic: All incentives need to be agreed with the Slovak Government and have to be formally applied for;
- All incentives are subject to limits set by EU law and must be approved by the EU;

It should also be noted that Slovak law and practice in this area has changed frequently in the past and is expected to change again in the future since draft legislation has already been prepared for a new Investment Stimuli Act. The final version of this new Act is not yet known but it is anticipated that incentives will continue to be discretionary and will be allowed in the form of corporate income tax relief (for a limited period), transfer of land at prices below market value, cash grants for acquisition of fixed tangible assets and intangible property; cash grants for education and training of employees and for the creation of new jobs.

Inflation

Inflation in Slovakia has recently been at low levels, hitting 2.7 per cent in spring 2002, which has contributed to a growth in domestic demand. Although this figure was down from 2001 inflation of 7.1 per cent, the National Bank of Slovakia expects the present rate to stabilize at around 4.2 per cent by 2005.

CONCLUSIONS

Slovakia's impressive reform program has accelerated the catching-up process and brought Euro area accession within reach.

Slovakia's combination of sound macroeconomic policies, comprehensive tax and social welfare reform, and new regulations for the product, capital and labour markets, has resulted in an acceleration of growth over the past five years and has increased the pace with which Slovakia is catching up to the living standards of wealthier nations. The coherence and consistency of the reforms, together with EU membership, has helped to convince large multi-national corporations that the Slovak economy is an attractive investment destination.

The penetration of foreign direct investment (FDI) has been high, with business investment particularly in the export-oriented manufacturing sector becoming the prime engine of capacity and output growth. FDI has brought with it new technology and better business practices, many of which have now trickled down to domestic firms who have been forced to compete in the more dynamic business environment. Indeed, productivity gains have been most notable in those sectors that have seen significant FDI inflows and in those where competition is strongest.

At the same time, interest rates, inflation, and the public deficit have been converging to European Union benchmarks, further enhancing the credibility of the reform agenda and increasingly facilitating the access of smaller firms to credit. Thanks to a robust increase in potential output, strong export and domestic demand over the past two years have faced no major supply constraints and the economy has remained on a balanced growth path of around 5% per year. Looking ahead, however, the extent of excess capacity in the economy is diminishing, suggesting possible risks for inflation.

Slovakia's introduction of a flat tax as part of wider economic reforms Slovakia's fundamental tax reform of 2004 considerably improved the simplicity and efficiency of the tax system by eliminating exemptions and special regimes and setting the rates for the personal income tax (PIT), the corporate income tax (CIT) and the value added tax (VAT) all equal to 19%.

This paper overviews also the impact of this reform in the context of Slovakia's wider package of economic reforms. With respect to economic efficiency, the two key conclusions are as follows:

First, the reforms are expected to improve both the level and efficiency of capital investment in Slovakia – although further improvements could be made by eliminating the double taxation on projects financed by retained profits.

Second, the combination of the tax and social benefit reforms has enhanced the incentives for unemployed workers to seek work, which should result in higher labour supply. Labour demand should also have increased, thanks to the more flexible labour market. However, as overall taxes on labour remain high, labour demand for very low skilled workers may not pick up without further reforms to reduce the cost of employing such workers.

With respect to equity considerations the assessment is less clear cut. On the one hand the flat personal income tax has benefited both low income earners and very high earners, particularly those with families, while middle-income earners, particularly single earners appear to be somewhat worse off. The increase in VAT and the welfare reform also have distributive effects. The net result of these reforms has been a significant cut in the real incomes of social beneficiaries who are not working. On the other hand, by raising labour productivity and reducing structural unemployment the reforms have the potential to benefit the low-skilled population also – provided other public policies are in place to facilitate this outcome.

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Further Readings, (Journals, Newsletters, Internet, etc…)

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