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Taxation of Western Enterprise in Selected European Socialist Countries

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I. INTRODUCTION

It is often argued that joint ventures in socialist countries represent a sudden new frontier for Western business firms. The present study suggests, however, that this "new opportunity" should be examined more critically and placed in a dynamic context. Western as well as Soviet-bloc enterprises (Yugoslavia, due to her special case, is not part of the latter group) have been through various stages of thought in regard to economic transactions with political adversaries:

(1) Cold War: National security concerns are dominant. One should not provide any tangible benefit to a political enemy which seeks your destruction. Thus the Western countries establish embargoes and Soviet-bloc states follow autarkic policies.

(2) Thaw: If the assumed economic gains exceed the estimated benefits of the adversary, then some limited economic transactions, subject to export controls, could be considered.

(3) Détente: The most important goal is the relaxation of political tensions; therefore, economic gains are secondary. In this stage, a limited number of Soviet-bloc countries invite Western equity capital investments to demonstrate the end of confrontation and also to seek abolition of discriminatory tariffs, changes in export control policy, and other benefits.

(4) Normalcy: Business firms, both Western and Soviet-bloc, seek profits and profitability within the system under which they operate, and political considerations do not play a significant role.

This project selects a single issue within the present détente and attempts to answer the question. "What are the fiscal rules in selected European Socialist countries that will apply to foreign corporations?"

The following areas will be investigated for Yugoslavia, Romania, Hungary, Bulgaria, and Czechoslovakia:

(1) The nature of limitations on the formation of foreign associations in various sectors;

(2) The types of business organizations (for example, corporate, partnership, branch office) in which foreigners may participate;

(3) The concept of taxable income, including the treatment of depreciation allowances;

(4) Types and rates of tax "normally" levied on corporate income and potential tax holidays.

II. GROWTH POTENTIAL

A. The Distribution of Employment. To demonstrate the growth potential of the selected socialist countries of Yugoslavia, Romania, Hungary, Bulgaria, and Czechoslovakia, we will use the so-called "snowflake diagrams," developed by the International Labour Organization.[1/]

Snowflake diagrams demonstrate the distribution of employment across the major sectors of an economy and can be used for the analysis and prediction of growth potentials. The sectors selected are: Agriculture, Manufacturing with Mining, Construction, Transportation, Commerce, and Services. The diagrams are constructed on a six-axis graph with the percentage share of each sector plotted on one axis. Immature less-developed economies are elongated upward along the agricultural axis. As the economy matures, the diagrams become more rounded; and, when the economy reaches the developed industrial stage, the snowflake "melts" as employment shifts heavily to the manufacturing and then to the services sectors (Table 1 and Figure 1).

It is proposed by the constructors of this model that in boom times an ample reserve of agriculturally employed labor is one of the basic ingredients of economic growth. The corollary of this proposition is, however, that the country should be ready to utilize current technological knowledge, to link her economy to the international market, and to keep population growth controlled. One way to achieve these goals is to establish joint ventures with developed industrialized countries. By this method, access to technology, secure capital formation, and knowledge of export and import markets are more readily available.

TABLE 1

Data of Snowflake Diagrams

(Figures are percentages of total work force employed in each sector)

	Ag	MM	Svs	Comm	Tran	Const
Bulgaria	64	16	11	3	3	3
Romania	70	13	8	3	2	4
Czechoslovakia	31	35	13	8	6	7
Yugoslavia	57	18	14	4	3	4
Hungary	36	30	16	7	6	5

Abbreviations: Ag -- Agriculture

MM -- Manufacturing with Mining

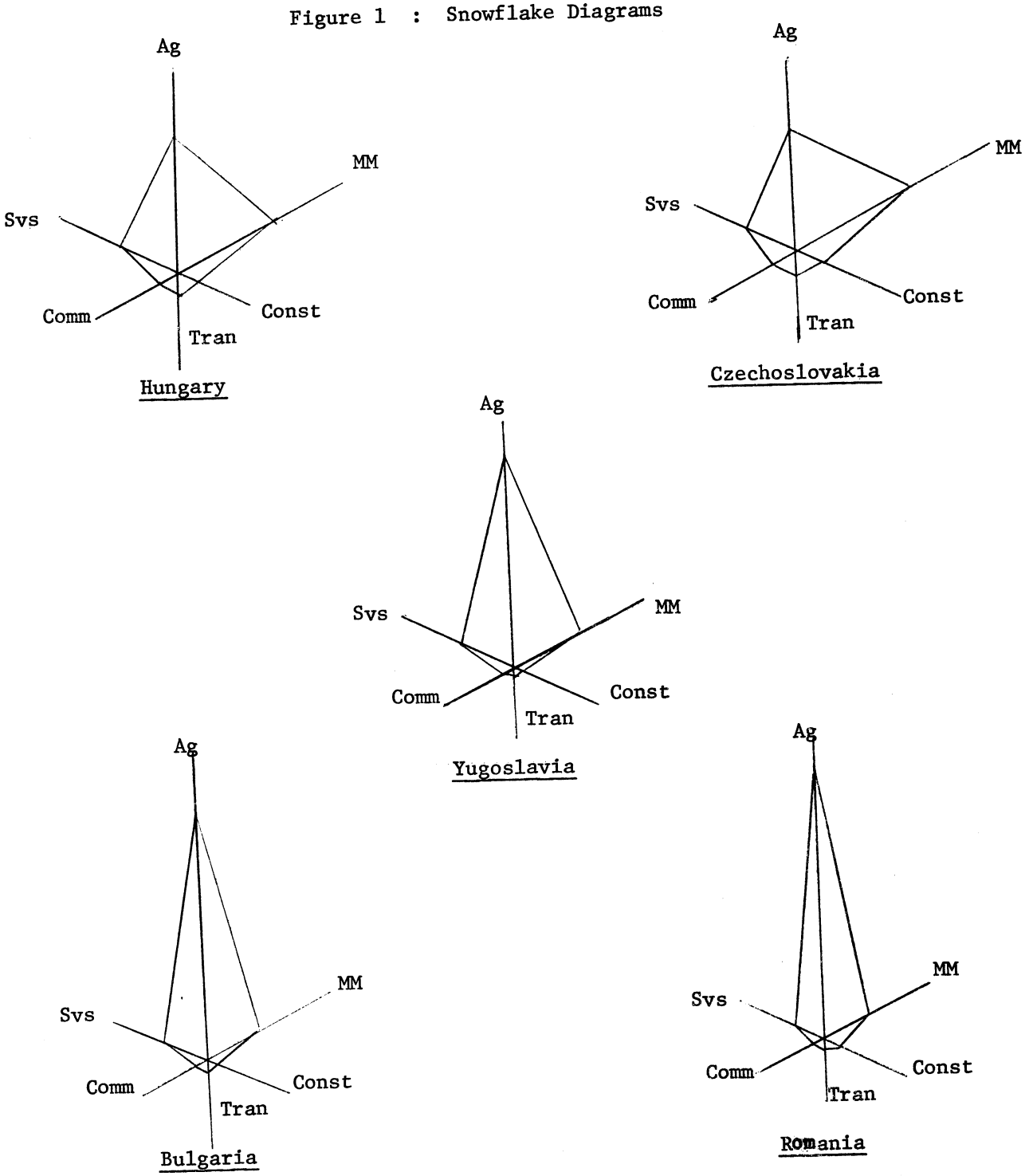
Svs -- Services

Comm --Commerce

Tran --Transportation

Const--Construction

Figure 1 : Snowflake Diagrams



Data Source: International Population Statistics Reports Series P-90.nos. 13, 14, 16, 18, 22. Bureau of the Census, U.S. Department of Commerce, U.S. Government Printing Office, Washington 25, D.C., 1960-1965.

B. Interpretation of the Diagrams. Given the snowflake diagrams of the selected socialist countries in Figure 1, the following conclusions can be drawn.

1. All five countries have relatively high levels of agricultural employment. This sector is often characterized by disguised unemployment and relatively low incomes. Western enterprise, therefore, can expect a readily available, relatively cheap labor force.

2. The countries which offer the largest labor pool appear to be Bulgaria, Romania, and, to a lesser degree, Yugoslavia. At this time, Bulgaria is not interested in joint ventures with Western enterprise. Thus, Romania and Yugoslavia, who actively seek foreign, equity-type investment, show the greatest potential for raw labor inputs.

3. Hungary and Czechoslovakia show more concentration in their respective industrial sectors and services. Thus, the labor pool in these countries is composed of more sophisticated workers who will require higher wages and benefits, but lower training costs should be incurred. However, Czechoslovakia is not now interested in joint ventures with U.S. firms.

4. The following rule-of-thumb can be summarized for Western enterprise seeking joint ventures with the selected socialist countries. In a production process characterized by a relatively low capital-labor ratio, Yugoslavia and Romania offer the best opportunities. (If regulations change, then Bulgaria should be included here as well.) However, if the production is characterized by a relatively high capital/labor ratio, then Hungary and, potentially, Czechoslovakia appear more attractive.

III. JOINT VENTURES IN THE SOCIALIST COUNTRIES

A. Definition and Purpose of a Joint Venture. The joint venture is a business association of comparatively long duration set up by two or more parties in order to run an enterprise subject to sharing of control, risk, and profit. The concept of the joint venture is not new in the European socialist countries. Such ventures have been created between Socialist and less-developed countries, and some socialist enterprises also act as investors in joint undertakings in "fraternal" socialist countries. These facts refute the often-heard allegation that one of the reasons for the hesitancy of some centrally-planned economies to enter into joint ventures is that the legal framework has yet to be defined.

The joint venture, as often stated, reconciles two interests. The foreign investor aims for the most effective protection for his property; moreover, he desires to enter a new market, to reach third markets through a new base, and to transfer production to a place where the costs of construction, labor, and so forth, are lower than in his own country. From the standpoint of the capital-importing host country, it is expected that the Western investor will furnish both tangible assets, such as machinery and materials, and intangibles, such as patents and skills.

B. Opening the Doors to the West. Price-directed, worker-self-managed, market-socialist Yugoslavia was the first socialist country[2/] to invite Western capital equity to incorporate in a joint undertaking.[3/] Everybody waited for the reactions of the other European socialist countries and these, with the obvious exception of Albania,[4/] were not unfavorable.

The German Democratic Republic and Czechoslovakia were among the first eleven foreign partners to conclude token joint venture contracts with Yugoslavia. The other countries of the COMECON group took the stand of expectation and exploration. The maverick of the Soviet bloc, Romania, was next to open the doors to Western Enterprise,[5/] with Hungary following thereafter.[6/]

C. Summary. The value of the joint venture depends on the degree to which it meets each partner's requirements. In the Western countries, as with all business associations, the joint venture is created to carry on a business that will generate profits. The usual objective of a firm in a centrally-planned framework is to maximize output or the volume of trade or services. These various objectives could conflict but they can also coincide. There is no general theory which can be offered, and every joint venture should be evaluated separately.

IV. THE CASE OF YUGOSLAVIA

A. General. On the basis of the Constitution and the laws, Yugoslav enterprises are autonomous self-managed organizations. They have full legal capacity, and are entitled to freely assess all factors involved in entering into business arrangements. The manager is not appointed by the central authorities but is selected on the basis of competition. In the case of a joint enterprise, the partners may agree that the foreign partner appoint an authorized person in his employ who would establish labor relationships with the enterprise. The title and capacity of this person is co-director, and he is not subject to formal approval by the workers' council.

Basically Yugoslav enterprises conform to market forces in accordance with the unique Yugoslav market-socialist system. The Yugoslav national economic plans are not legal, binding obligations; they are mainly guidelines, similar to the French plans. The enterprises are entitled to draw up their own development and investment plans.

The enterprises themselves distribute realized income and allocate it to various funds and to personal income (wages and salaries). Therefore, in Yugoslavia, there is very little check on increasing wages, since the workers' councils decide wages.

B. Ownership. Under ordinary conditions common to western economies, equity investment constitutes ownership. But if one of the investors is from a Western country, and the joint business venture is in a socialist country, is this capitalist the partial owner of a socialist firm? This

is a touchy question. It does indeed seem contradictory that countries which, in accordance with the prescription of socialist theories, expropriated their own capitalists, would now invite the cooperation of Western enterpreneurs to pocket the Marxian "surplus value", that is, the profits. Yugoslav theorists were much concerned to provide an acceptable solution for this puzzle.

The Yugoslav solution is elegant and may provide a blueprint for all those nations which badly need foreign capital in order to solve some of their economic ills but, at the same time, are hesitant to invite foreign capital into their economy. Yugoslav theoreticians propose that at the very moment the foreign capital crosses the border of a country, it becomes socially owned. It is claimed that investment coming from Western investors is not associated with capitalist assets in the socialist country, since the capitalists are not co-owners of the joint undertakings.

This solution is derived from the concept of Roman law, namely from the term instituta pactum reservati domini. This doctrine is practiced in trade as a sort of security for the seller that the buyer will fulfill the contract. A car remains in the ownership of the dealer until all the payments are made, but it is operated and used by the buyer. Similarly, the foreign investor can use the whole part of his share, but he does not own it. While he retains title to his invested assets, this does not violate Article 8 of the

Federal Constitution which lays down the principle that "no one has the ownership to the social means of production and that the means of production and other means of social work....are social property." The word "ownership" was also carefully left out in the entire foreign investment legislation.7/

The rights of the foreign investor, in spite of the fact that he does not own any assets in the Yugoslav economy, seem quite secure. The regulations provide that he may share in the profits from the joint venture "as long as he participates in it with his own assets" and also that he has the right to the return of the particular items invested in the joint venture. The foreign investor, therefore, subject to the contract, could retrieve his entire equity regardless of its form (cash, tangibles, intangibles); practice has demonstrated and confirmed this option. Therefore, a piece of machinery which has a lifetime of ten years can have an interesting metamorphosis. Used by a foreign investor as equity in a Yugoslav investment, it becomes socially-owned property, but if the investor returns home after five years the machine, in a new reincarnation, again becomes private property.

C. Restrictions on Foreign Investments. Host governments often impose limits and restrictions on foreign investments, and regulations are often made which exclude foreign capital from certain areas of activity. The Yugoslav approach is the following: banking, insurance, inland transportation, internal commerce, public utilities, and social services are areas or sectors in which all foreign investment is excluded.

An exception can be made by the Federal Executive Council if it decides that a particular investment will expedite the development of a certain sector. So far, the Council has not used its powers in this respect although potential foreign investors have been interested in entering complex projects involving inland transportation. Some sectors, such as manufacturing, processing, the extractive industries, agriculture, tourism, and research, are open for foreign participation and for registration with the government.

A special territorially-determined area of foreign investment is a free custom zone. In Yugoslavia, nine such zones have been registered: Beograd, Novi Sad, Rijeka, Koper, Split, Zadar, Ploce, Bar, and Pula. Article 2 of the respective decree enumerates activities using foreign equipment that may be jointly run within these zones: storage of goods, perfection of foreign goods, usual handling of goods such as classifying and packaging, and erection and financing of other facilities. Amendments to include activities such as industrial manufacture coupled with custom-free import of foreign-invested equipment have been proposed.[8/]

D. Taxation of Joint Ventures.

1. Gross Income, Net Income, and Profit. Joint venture contracts in Yugoslavia have adopted the same systems of income reporting, computation of profits, and accountancy as all domestic enterprises. Accordingly, gross income is the total receipts accrued from invoiced sales of product and services. Net income, or simple income, is gross income minus the cost of material and services and depreciation of fixed assets (domestic and foreign).

Material costs and services include raw and other materials used, services of third parties, rent, advertising and promotion, costs of participation in fairs, maintenance of fixed assets, purchase of protective devices and clothing for workers, transportation for workers, and emoluments of apprentices.[9/] The Western reader may be astonished not to find labor costs in this enumeration. Under worker self-management, labor costs are not considered expenditures since they are received by the "owners" of the enterprise.

Before becoming distributable profit, net income is reduced by various contributions. The foreign partner, in general, does not escape any contribution that affects his Yugoslav counterpart, unless previously negotiated by contract. The income of the enterprise is not taxed; rather, the worker's personal income (wages and salaries) is taxed. Legal[10/] and contractual [11/] reserves are additional obligations. In some cases, part of the net income must be allocated to the enterprise funds prior to distribution to the parties; this should be clarified in the contract. The remaining net income is the distributable profit.

2. Distribution of Profits. On distribution of profit, the law is flexible. The foreign partner can take his share out in accordance with his percentage of equity in total assets, whereas the domestic partner can use his share in two ways: (1) for salary/wage bonuses; (2) for allocation to the enterprise's funds. The law does not require that the shares in net distributable profits be proportionate to each partner's contribution but, in practice, all contracts concluded so far demonstrate that the equity ratio was the sole criterion.

With regard to losses, the contracts provide that either the parties will share in the losses in proportion to their investments or the losses will be offset against the income. In either case, the losses reduce the tax base.

3. Withholding Tax Affecting the Foreign Partner. Once the foreign partner's share of distributable profit has been decided, a special withholding tax of 35 percent is levied, after which that share is transferable. This tax is applicable only on the foreigner's share of profit, and is executed by monthly estimated payments during the calendar year, unless the recipient enterprise draws its balance sheets quarterly. Both partners are held liable for any failure to pay the tax.

Royalty payments are also subject to a municipal withholding tax at rates set locally up to a maximum rate of 30 percent on the gross royalty reduced by a fixed percentage for expenses. (Domestically, the tax applies only on royalty payments to individuals.)

4. Tax Incentives. The Yugoslav federal legislation grants a concessionary reduction of the 35 percent tax in proportion to the percentage of profit that the foreign investor ploughs back. The reduction may be as much as 90 percent. As the reinvestment rises, the reduction increases. The foreigner enjoys the same concession on the percentage of profit he deposits in a bank, if it is longer than ten years. If the deposit is for at least five years, the concession is half; however, the tax concessions are not applied if the withdrawal period is less than five years. Interest on the deposit of the foreigner's profit is not taxable.

5. Differential Taxation Between Republics. Sweeping changes in the field of taxation are expected, as all the republics, both developed and undeveloped, are now entitled to tax foreign investors according to their statutes. The tax may not exceed 35 percent but may be lower. Foreign investors should be aware of local regulations. For example, while the levy on the foreigner's profit from joint investment is 35 percent in Serbia and Slovenia, it is reduced to 20 percent in Bosnia-Herzegovina, and to 14 percent in Macedonia.[12/]

6. Summary. There are two categories of required payments affecting joint ventures in Yugoslavia: (1) required contributions, and (2) the profit tax payable by the foreign partner. The foreign partner's share of some of the contributions may be negotiated in the contract, such as legal reserves and social insurance contributions. Then the foreigner pays the 35 percent withholding tax on his share of the profits.

V. THE CASE OF ROMANIA

A. General. Romania, the maverick of the Soviet bloc, conducts her foreign relations more or less independently of the Soviet Union and the rest of the COMECON countries; at the same time, she maintains a tight grip on her domestic economy, which is one of the strictest centrally-planned systems in East Europe. Romania's trade with COMECON and "other socialist countries" has been decreasing, while trade with Common Market and less developed countries has been increasing. (For example, trade with the United States in 1974 approached $200 million compared with $116 million in 1973.) At the same time Romania follows the "Preobrazhensky-type super-industrialization" concept of forced industrialization which dominated Soviet economic policies during the Stalinist period. Each economic plan stresses a high rate of industrial expansion.

B. Ownership. Decree No. 425 of November 2, 1972 on Tax and Profits of Joint Companies Constituted in the Socialist Republic of Romania, permits foreign ownership of as much as 49 percent of the equity in Romanian joint ventures. This represents a fundamental change in the earlier Romanian position, which demanded "exclusive ownership of all joint economic units established in Romania." The 1972 Decree was an attempt to introduce new methods designed to alleviate the chronic deficit in Romania's trade balance, especially vis-á-vis the Western industrialized nations. It was hoped that joint ventures with Western companies would improve this situation.

C. Taxation of Joint Ventures.

1. Determination of Gross Income, Net Income, and Profits. The accounts of the joint venture are not kept in the local currency but in the so-called "agreed currency". (Some minor exceptions to this rule are enumerated in Article 21.) The "agreed currency", although not stated explicitly, is usually the currency of the foreign partner. If the foreign partner's country lacks convertible currency, then the accounts are kept in a selected hard currency.

The association is separated from the actual prices of the local markets, for the internal pricing system of Romania is divorced from the world market pricing system. Local currency expenses, such as the wages of local employees and domestic supplies, are paid by the Romanian authorities in lei and billed to the joint venture in hard currency. How are costs arising from the usage of domestic resources determined? The unit price of the domestic inputs should be negotiated in the contract in terms of the hard currency selected. The bill will come from the state authorities and not from the vendor. The contract price is usually lower than the price for labor, raw materials, and so forth, in the investor's home country, but not as low as the costs of these inputs faced by a Romanian firm. Romanian authorities rightly feel that it would be unfair to sponsor the operation of a joint venture from the sacrifices of the Romanian population which would be required to maintain an artificially low price level on input prices.

The same principles apply to sales by the joint companies to domestic enterprises. The price will not be paid in lei by the buyer but will be

reimbursed by the Romanian authorities in the selected hard currency on the basis of the negotiated output unit price.

The calculation of net income would be simplified if the company's operations were exclusively domestic. Then, the company's net income would be determined on the basis of the negotiated prices for local inputs and sales of output. No part of the net income could be transferred abroad; it could be reinvested in the joint venture or in another association. However, significant transactions of the joint venture may be international, for which prices are determined exogenously by the international market. The Romanian stand is that, while for domestic purposes a distorted price system is a must to achieve various objectives, the international exchange of goods and services even among socialist countries cannot ignore objective laws and one cannot superimpose an artificial price structure. Thus the net income for such international transactions is divided in accordance with the equity between the domestic and foreign partners; after taxes, the share of the foreign investor can be repatriated.

Net income is also reduced by depreciation allowances and legally required reserves. Depreciation is dealt with in Article 27, which states that the rates of depreciation should, generally, be established in the Contract of Association but that they may not be lower than the standard rates laid down by Romanian laws. A deduction of 5 percent of annual profit may be taken each year for amounts set aside in a tax free reserve fund until the reserve reaches 25 percent of invested capital.

2. Tax Rates and Tax Holidays. A 30 percent tax is levied on the joint venture's annual net income. However, profits reinvested for at least five years in the same or other joint ventures are taxed at a reduced rate of 24 percent. Moreover, new companies may be granted a tax holiday or full exemption for the first profitable year of operation and taxation at half the ordinary rate (that is, 15 percent if distributed, 12 percent if reinvested) for the following two years.

3. Distribution of Profit. The net profit after tax can be

(i) appropriated to form voluntary reserves;

(ii) ploughed back to finance fresh investments;

(iii) paid out to the shareholders as dividends;

(iv) any combination of (i), (ii), and (iii).

The share of each appropriation may be determined by an enterprise policy formulated in the Contract of the Association or it can be determined by the General Assembly of the shareholders.

As regards repatriation of dividends by the foreign partner, the situation is not totally clear. The likely situation is that the amount that can be remitted abroad will be limited to the foreign investor's share of hard currency in the international account, in accordance with the proportion of the foreign partner's equity. For example, assume that the net profit is $100, of which 40 percent originates from domestic operations and 60 percent originates from international operations. Further, suppose that the foreign partner's investment is 40 percent of total assets. Then, if no appropriations are made from the international

account to voluntary reserves or reinvestments, the foreigner could presumably remit 40 percent of the $60, that is, $24.

Dividends remitted abroad are subject to a 10 percent withholding tax.

4. Avoidance of Double Taxation. Romania has concluded income tax treaties to avoid double taxation with the Federal Republic of Germany and with the United States. The U.S.-Romania treaty was signed on December 4, 1973. It entered into force in January, 1976; but applies retroactively to January 1, 1974.

VI. THE CASE OF HUNGARY

A. General. The study of Hungarian economic policy in the 1960s shows how changes in economic mechanisms and policy concepts can be made in a market economy that is open, planned, and noncapitalist. A new economic model--the New Economic Mechanism (NEM)--went into operation in January, 1968. It is based on the following principles.

(a) In a relatively developed industrial society with an extensive domestic and international division of labor, the most efficient form of organization of economic activity is the market exchange system, regardless of the form of ownership.

(b) Because the means of production are publicly owned, the operation of the market can be regulated in such a way as to eliminate those disturbances which occasionally disrupt economic processes in a private enterprise system.

(c) The basic instrument and control for the socialist market economy is the macroplan. The plan has the same economic aims and objectives as the Government, and it indicates the instruments at the Government's disposal. The market and the price system provide signals for the planners which warn them that investigations and interventions are necessary to "guide" the economy in the desired direction. Therefore, the plan acts as a correcting mechanism.

(d) The success indicator for efficiency is profit, a measure of success and an automatic regulator of income distribution.

(e) Competition is necessary; indeed it is an indispensable part of the mechanism for adjusting to a market equilibrium.

(f) Such an economy needs a relatively free price system. It cannot function properly without the automatic adjustment carried out in response to constant changes in relative prices.

(g) Decision-making should be decentralized. A limited number of macrodecisions should be made by central authorities while microdecisions taken by the economic units aim to achieve the goals more efficiently.

The New Economic Mechanism stresses the concept of cooperation with Western enterprise. Industrial cooperation with the firms of the developed industrial nations is considered one of the most important aspects of economic development because, as stated, "we must find substitutes for imports at any price."

B. Ownership. In 1970, Hungary announced the principle of partnership between foreign and local firms, including enterprises from the Western industrialized nations. The conditions were elaborated in October 1972 in a short decree which leaves many issues to be filled in by regulations. Specific agreements for joint ventures can be obtained rather easily, and should be incorporated in the contract.[13/]

Joint ventures in Hungary, with respect to ownership, normally take the form of joint stock or limited liability companies. The limit to foreign equity participation is not spelled out in the Decree, but it is normally 49.9 percent (which can be relaxed, especially if several Western firms would like to participate in the undertaking).

It is an interesting provision of the Decree that the foreign partner may apply to the Hungarian National Bank for a guarantee to secure the right of its ownership against any damages which may result from direct or indirect acts of the Hungarian state or of the Hungarian counterpart.

If the venture is in commercial or service activity, then only the concurrence of the Ministry of Finance is needed for a contract (which is called a "memorandum of the association"). If the venture holds industrial assets and engages in industrial production, then the approval of the Council of Ministers is necessary. In Yugoslavia and Romania, authorities seek primarily industrial joint ventures engaged in sophisticated production processes using forms of superior technology. To date, joint ventures in Hungary are concentrated in services, trade, or assembly of kits.

C. Taxation of Joint Ventures.

1. The Determination of Gross Income, Net Income, and Profits. Decree No. 28 of 1972, issued in accordance with section 31 of Law-Decree 19 of 1970, defines the financial conditions of establishing, functioning, and terminating joint ventures. In accordance with Hungarian financial law, joint ventures are considered to be Hungarian enterprises; to a large extent the rules and procedures governing their money circulation, order of accounting, formation of funds, definition of profits, and taxation are the same as those governing local enterprises. Related questions may be regulated in the contract.

Gross income is defined in Hungarian book-keeping as the value of all goods and services sold in the internal and international operations. The gross book-keeping profit (net income) is the difference between gross income and the aggregate of the fixed and variable costs of the joint venture.

The measure of profitability is often used in Hungary to establish the success of business enterprises. If gross income is Y and gross profits is S, then profitability P is measured by the ratio: $P = S/Y$.

For Hungarian enterprises, the gross book-keeping profit is increased by the increment of the wage fund, but joint ventures are exempt from wage increment levies. The gross book-keeping profit is diminished by depreciation deductions and by the sums set aside for the risk fund. The rate of contribution to the risk fund should be outlined in the contract of the association; the fund is increased until it equals 10 percent of the capital of the association. After deduction of the risk fund, the association may create a so-called employee's participation fund out of gross profits. However, the amount of this fund shall not exceed 15 percent of total wages and salaries.

The regulations do not prescribe any further mandatory formation of additional reserves or funds, and the remainder of the gross profits represents the so-called profit-sharing funds (net profits subject to taxation).

2. Tax Rates and Tax Holidays. The profit-sharing fund, which can be considered as net profits, is taxed at 40 percent or 60 percent--40 percent if the rate of profit (measured as the ratio of gross

bookkeeping profit to the association's net assets) is 20 percent or less and 60 percent if the profit ratio is over 20 percent. The tax paid on profits reinvested in the joint venture may be refunded on special application to the Ministry of Finance; the rules on this are not clear, however, and should be clarified in the contract.

There are also social security contributions for which the employer's share is about 17 percent of the wage bill and an 8 percent payroll tax.

There do not seem to be any tax holiday exemptions from profits tax.

The after tax balance is divided according to the equity participation of the investors. The foreign investor's share may be remitted abroad without any withholding tax.

In the case of Hungarian firms the profit-sharing fund after taxes is often augmented by grants from ministries (such as contributions to low-cost meals provided for personnel, allowances granted to workers going through personal difficulties, subsidies to cover expenditures on day nurseries and other child-care services); premiums granted to enterprises which have achieved particularly impressive records; and special tax incentives to exporters.

When discussing the contract with the Hungarian firm and authorities, the question of possible miscellaneous contributions to the profit-sharing fund from outside sources based on the principle of equal treatment can be raised. This is particularly important with respect to the tax preferences on profit from export activities. These preferences

extended to 158 enterprises in 1972, and yielded a reduction of about 10 percent in the total profit taxes of those enterprises. The preference amounts to 2.7 forints per export dollar earned.[14/]

Joint ventures in Hungary can probably expect better conditions for their international operations in the near future. Hungary has applied for GATT membership, and this would involve a significant reduction of domestic tariffs.

3. Avoidance of Double Taxation. There is a possibility that some problems of taxation will be alleviated by tax treaties subject to the principle of reciprocity. According to Section 11 of Decree No. 28 of 1972 of the Minister of Finance, "while implementing international agreements on double taxation, the standpoint of the Minister of Finance is decisive in the question of reciprocity." Hungary has some such agreements concluded prior to 1950, with Austria (Act XL of 1925), Italy (Act XXIV of 1928), Sweden (Act XXV of 1937), the Netherlands (Act V of 1940), and Switzerland (Act VI of 1949). A new treaty with Austria is under discussion.

D. Financial Operation. The hard currency of the joint enterprise should be recomputed to local currency at the exchange rate or exchange coefficient agreed upon by the representatives of the foreign company and the officials of the host country. This should be subject to readjustments, and disputes should be settled by arbitration before an international forum, such as the Chamber of Commerce in Zurich. Hungarians, until now, have always accepted the position of the International Chamber of Commerce on disagreements between the partners.

VII. THE CASE OF BULGARIA

A. General. Bulgaria's aim is to bring her economy more and more in line with the Soviet pattern, and her state plans are formulated according to the philosophy of cooperation with the Soviet Union. The Soviet Union is reluctant to allow on her soil equity-type joint ventures between domestic enterprises and Western corporations, and this stand is also taken by Bulgaria.

Bulgaria's per capita GNP is the lowest among the European socialist nations, but it is growing fast. Yearly increases, measured in real terms, are around 9 per cent, and are greatest in the industrial sector. An area of disappointment for Bulgarian planners is agriculture. Labor shortages and out-of-date equipment in the agricultural sector are responsible for poor performance. This explains the interest of Bulgarian policy-makers in technologically sophisticated Western agricultural machinery. Other interests are mainly telecommunication equipment, pharmaceuticals, non-electrical machinery, and mechanical appliances. Lately, Bulgaria is interested in obtaining electronic, oil extraction, and ship-building equipment.

Bulgaria's recently signed free trade agreement with Finland, eliminating trade barriers between the two countries, is reportedly the first of its kind between a centrally-planned and a price-directed economy. A barrier to U.S. and Bulgarian trade is Bulgaria's inability to receive U.S. Government credits until an agreement has been reached on defaulted bonds issued by the Kingdom of Bulgaria and presently held by U.S. citizens.

Bulgaria is interested in foreign cooperation on "turnkey" projects. Such a project might involve a Western firm supplying, for example, a tractor plant, which it turns over to Bulgarian authorities ready for operation. Purchase of the plant and equipment may be backed by government-guaranteed Western credit, and the Western firm may agree under a long-term marketing agreement to purchase tractors, engines, or parts from the completed Bulgarian firm, paying in hard currency which the Bulgarian firm uses to pay for the plant, plus interest.

At the end of 1974, the Bulgarian government adopted new legislation on "economic, industrial and technical cooperation with foreign juridical and physical persons." This legislation does not permit direct Western equity investment in the Bulgarian economy, but it has established the conditions for Western companies wishing to invest in the Bulgarian economy. It is sometimes claimed that this legislation, in practical terms, allows Western corporations to draw benefits similar to those of the joint ventures.

B. Regulations on Foreign Economic Cooperation. On June 12, 1974, the Bulgarian State Council issued a brief decree, No. 1196, on economic, production, and technological cooperation with foreign firms and individuals (Darzhaven Vestnik, No. 46, June 14, 1974), which specified that the Council of Ministers should issue detailed regulations on its implementation. These regulations have now been published (Darzhaven Vestnik, No. 73, September 20, 1974), and give a clearer idea of the range of joint activities envisaged within the framework of expanding economic relations. The

decree begins by stating that "economic, production, and technological cooperation between Bulgarian economic organizations and foreign firms and individuals is being encouraged." To this end, "favorable planning, financial credit, customs, and other conditions are being created," and fulfillment of the obligations assumed by Bulgarian enterprises is guaranteed.

Both the decree and the regulations state that a foreign firm or individual, by sending specialists, may participate in measures undertaken by a Bulgarian economic organization to increase labor productivity, improve organization of production, introduce new technologies, or sell its products on the international market.

C. Summary. Bulgarian joint ventures are limited and intended primarily to help Bulgarian firms export their products, through technical assistance or "turnkey" projects for which she usually compensates the Western firm with actual produce.

Ukaz No. 85 of August 31, 1974, by virtue of an unfinished sentence, seems to suggest that provision might be made in the future for establishment of corporate joint ventures producing on Bulgarian soil, but this seems unlikely until the time that such ventures are established in the USSR. One cannot expect Bulgarian policy-makers to follow the Romanian or Hungarian patterns.

With respect to corporation income, Bulgarian taxes follow the Soviet model strictly, and no taxes are levied at present on the income of foreign enterprise operating cooperatively in Bulgaria.

VIII. THE CASE OF CZECHOSLOVAKIA

A. General. Before the August 1968 invasion of Czechoslovakia by the Soviet Union, the policy of the Czechoslovak government, as described by the economic architect of the Prague Spring, was "to take advantage of offers to cooperate with Western firms in order to modernize plants and to introduce new and more effective production and, in addition, with the help of the Western partner, to penetrate markets that our country has abandoned on its own accord or that have been closed to us over the past twenty years."[15/]

After the Soviet invasion, the goal of the country can be summarized as the "full restoration of the socialist character of the society and economy." This means, as various symposia have demonstrated,[16/] that the key problem is the question of socialist ownership and its defense "against bourgeois ideologists and revisionists."

In this atmosphere, complicated by other international problems such as the question of Czechoslovak gold reserves held by the United States, it is highly unlikely that joint ventures in Czechoslovakia can be established with Western firms. Yet, the country has a serious handicap in the investment sector which has existed for a number of years and which the Finance Minister calls "our Achilles heel".[17/] Czechoslovakia is deeply in need of Western investments. A new "Law on Procedures for the Concluding of Agreements on Economic Cooperation with Countries Abroad" (No. 85/1972, published in Sbirka Zakonu) was promulgated. However, in spite of its promising title, it seems designed to restrict cooperation with the West and favors autarky in the field of technological development.

B. Summary of Western Cooperation with Czechoslovakia. "Doing business with Czechoslovakia" is extremely difficult for Western firms, although relations with the industrialized countries and even the problems of joint ventures are occasionally discussed in Czechoslovakia.[18/] Czechoslovakia will probably be the last country in the Soviet bloc to permit joint ventures on her soil.

The reasons for this are political. Czechoslovak leaders are now eager to prove that their country is not "Western-oriented"; they are sensitive to such criticism since, among the European socialist states, Czechoslovakia has the most sophisticated labor force, the most developed economy, and the most internationally oriented population (the German Democratic Republic notwithstanding).

IX. CONCLUSION

The only socialist countries which have issued legislation or decrees to allow equity-style joint business ventures with Western companies on their soil are Yugoslavia, Romania, and Hungary. The remainder of the European socialist states, which with the exception of Albania are part of the Soviet bloc, follow the example of the USSR, which does not recognize Western capital investments in her economy.

The following outline summarizes the regulations related directly or indirectly to taxation:

A. Accounting Procedures

1. Yugoslavia.

   a. Joint ventures in Yugoslavia are based on the concept of "free contractual regulations"; therefore, all accounting rules should be included in the contract.

   b. The Yugoslav partner is required to maintain separate accounts.

   c. The calendar year is taken as the time unit reflected in the balance sheet.

2. Romania.

   a. The accounting system should be outlined in the contract.

   b. Romanian personnel are paid in domestic currency, and this should be purchased on the basis of a separately determined exchange rate from the Romanian National Bank.

   c. All hard currency payments of the joint business venture must be generated from funds of the business venture or financed by loans coming from abroad.

3. Hungary.

a. The accounting system should be outlined in the contract and approved by the Ministry of Finance.

b. A "risk fund" should be set aside in accordance with the contract of the joint venture; annual losses can be charged against this fund.

c. Operations which use foreign currencies and raise credits are guided by the same rules as domestic organizations.

d. Wages and contracts with local personnel should be in accordance with Hungarian statutory rules and approved by the Ministry of Finance.

B. Business Taxes.

1. Yugoslavia.

a. The domestic partner is obligated to pay the tax and the foreign investor should provide his share which is ordinarily 35 percent of profits, but is reduced on reinvested profits.

b. There is a variation in the rate of taxation between Republics; in the undeveloped parts of the country the rates are considerably lower.

c. If the Western partner keeps at least 20 percent of his profit in a local bank, he may be exempted from tax on interest earned on these deposits.

d. Royalty income is taxed at graduated rates of 10 to 25 percent on net royalties.

e. Personal service income taxes, including social security taxes, may be as high as 70 percent.

2. Romania.

a. Romania taxes the joint venture's annual profits at a rate of 30 percent.

b. An additional 10 percent withholding tax is levied on distributions to nonresidents.

c. If profits are reinvested for a period of five years, then profit taxes are reduced from 30 to 24 percent.

d. Tax exemptions may be granted from the Council of Ministers for the first year and tax reductions (up to 50 percent) for the following two years.

3. Hungary.

a. Profit taxes are imposed at 40 percent or 60 percent. The rate is 40 percent if the profits are up to 20 percent of the net assets and 60 percent if the profits exceed 20 percent of net assets.

b. If profits are reinvested, the taxes on those profits may be reimbursed.

c. Pension contributions and social security payments are the same as for domestic firms, 17 percent.

C. Transfers.

1. Yugoslavia.

a. The foreign partner is free to transfer his share of net profits abroad, provided that the enterprise has the foreign exchange at its disposal.

b. The foreign partner is permitted, under some circumstances, to withdraw all or part of his investment.

c. The source for foreign currency for repatriation is the retention quota, which is 20 percent of export proceeds for all industries and 45 percent of revenue generated from tourism. In addition, an allowance of convertible currency allocated to joint ventures amounts to 33 percent of its export proceeds. For remittance of investment, these sources are amended by an annual allowance of 5 percent of depreciation.

2. Romania.

a. The foreign partner is free to transfer his share of net profits abroad from the enterprise foreign exchange fund.

b. Such transferred profits are subjected to a 10 percent dividend withholding tax. (Interest payments abroad are taxed 15 percent and royalties 20 percent; however, these rates are reduced in some cases by the United States-Romania income tax treaty.)

c. The portion of the profit which goes to the reserve fund cannot be transferred abroad.

3. Hungary.

a. Net profits are transferable, and capital repatriation in convertible currency, after payment of taxes, is secured.

b. The foreign partner can withdraw tax-free his share of the association in accordance with the rules stipulated in the contract of the association.

c. Foreign personnel are limited to transferring abroad 50 percent of wages or salaries.

D. The Future. The practical implication of this study is that, if a long-run investment is considered in the Socialist countries, then Western investors should seek stable concessions, such as adequate depreciation deductions, in their contracts. Business contracts in these countries are still flexible and special concessions can be achieved by *quid pro quo* bargaining.

Equity-style business ventures are welcome in Romania and Hungary and may have prospects in Yugoslavia, but positive prospects for the same type of establishment in the command economies of the Soviet bloc may be overestimated. The non-equity type of association, which totally excludes the foreigner from direct ownership in the business association, is regarded by the majority of the Soviet-bloc countries as the most proper form of association with developed Western industrial countries.

FOOTNOTES

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I bear the sole responsibility for the views expressed.

1/ Vide, for a description, "Melting Snowflakes", Economist, Vol. 235, December 28, 1974, pp. 42.

2/ With respect to travel regulations, the centrally-planned COMECON countries exclude Yugoslavia from the socialist countries.

3/ Official Gazette, No. 31/1967. The Federal Assembly of the Socialist Federal Republic of Yugoslavia, July 1967.

4/ Radio Tirana broadcast: "Yugoslavia opens her door to Western monopolistic capital and subjects the Yugoslav economy to enslavement along with twofold increase of exploitation of domestic workers." Radio Free Europe monitoring Radio Tirana on October 4, 1968, 3:30 p.m.

5/ The Grand National Assembly of the Socialist Republic of Romania passed a bill (Bill No. 1, Official Bulletin, March 17, 1971) on Foreign Trade and Economic and Technico-Scientific Cooperation Activities. A subsequent bill dealing with questions of fiscal regulations and distribution of profits was passed by the State Council (Decree No. 425 on Tax and Profits of Joint Companies Constituted in the Socialist Republic of Romania, Official Bulletin, November 2, 1972).

6/ The Minister of Finance, Lajos Faluvégi, issued a decree on Economic Associations with Foreign Partners: Decree No. 28/1972, Official Gazette of the People's Republic of Hungary, No. 76, October 3, 1972. See also International Legal Materials (4) 989, (1973).

7/ The Hungarian decree speaks about "the foreign partner's share" in paragraph 11/41; the Romanian decree speaks about the "share of the parties" in several places.

8/ Such proposals in the zones of Beograd, Rijeka, and Koper have been backed by the Assemblies of S.R. Croatia and S.R. Slovenia. They are still pending.

9/ Law of Formation and Computation of Total Receipts and Income in the Basic Organizations of Associate Work, published in the Official Gazette of the SFR of Yugoslavia, No. 71/72, pp. 1427.

10/ Legal reservations affecting income include contributions for the use of urban ground; water rate; turnover tax; contribution for mandatory joint reserves of economic organizations paid to the commune or republic within which the enterprise is located.

11/ Contractual reservations affecting income include loan and interest payments; insurance premiums; bankers' commissions; membership fees to chambers, associations, etc.

12/ Vide, A Law on Income Tax of the Organizations of Associated Work, The Official Monitor of the S.R. of Serbia, No. 4/73, pp. 83; The Official Gazette of the S.R. Bosnia-Herzegovina, No. 36/72, pp. 1057.

13/ Edward A. Hewett, "The Economics of East European Technology Imports from the West", The American Economic Review (May 1975), pp. 377-82; Paul Marer, Hungary's Industrial Cooperation with the West: Achievements, Problems and Perspectives (October 1975), prepared for the U.S. Chamber of Commerce.

14/ I. Orszagh, "Analysis of the Operation of the Profit Tax Preferential Export Incentive System", Kylgazdasag, 17, 1973, No. 11 pp. 813-24.

15/ Ota Sik, Czechoslovakia : The Bureaucratic Economy (Vienna 1973). pp. 112.

16/ Symposium on Socialist Ownership (Prague, October 17, 1974).

17/ Rudolf Rohlicek, "The Investment Sector : Our Achilles Heel", Pravda (Bratislava, May 4, 1973).

18/ "Economic Cooperation is the Great Interest to our Economy", Hospodardke Noviny (Economic Weekly), October 15, 1974.

A LIST OF YUGOSLAV STATUTES

RELEVANT TO TAXATION

A. Income

The Law on the Establishment and Computation of Total Receipts and Income in the Basic Organizations of Associated Work (Official Gazette of the SFRY No. 71/72).

B. Taxation

The Law on Profit Tax Payable by Foreign Persons Investing in a Domestic Economic Organization for Running Business in Common (Official Gazette of the SFRY Nos. 31/67 and 9/68).

The Law on Profit Tax Concessions Favoring Foreign Persons Investing in a Domestic Organization for Running Business in Common (Official Gazette of the SR of Montenegro No. 23/69).

The Law on Profit Tax Concessions Favoring Foreign Persons Investing in a Domestic Organization for Running Business in Common (Official Gazette of the SR of Macedonia No. 42/71).

The Law Supplementing the Law on the Establishment of Interest Rates on the Funds in the Economy (Official Gazette of the SFRY No. 31/67).

The Law Supplementing the Basic Law on the Contributions and Taxes Payable by Citizens (Official Gazette of the SFRY No. 31/67).

The Decision Concerning Special Contributions, Income, Auditing and Profit Taxes Payable by the Foreign Contractors of Investments Works in Yugoslavia (Official Gazette of the SFRY No. 15/67).

C. Bookkeeping and Auditing

The Law on the Bookkeeping in the Work Organizations (Official Gazette of the SFRY No. 48/68 and 56/69).

The Law on the Revaluation of the Assets of the Organizations of Associated Work (Official Gazette of the SFRY No. 50/71).

Directive on How to Materialize Revaluation of the Assets of the Organizations of Associated Work and to Report for the Sake of Social Records (Official Gazette of the SFRY No. 51/71).