STIKK

SHOQATA PËR TEKNOLOGJI TË INFORMACIONIT DHE TË KOMUNIKIMIT TË KOSOVËS

KOSOVO ASSOCIATION OF INFORMATION AND COMMUNICATION TECHNOLOGY

Unleashing the Export Potential of Kosovo ICT Companies

Structured Approach to Sectoral Export Promotion

POSITION PAPER

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Contents

List of Abbreviations

BPO	Business Processes Outsourcing
CEE	Central and Eastern Europe
DACH	Deutschland/Germany, Austria, Switzerland
EC	European Commission
EU	European Union
FDI	Foreign Direct Investment
FYROM	Former Yugoslav Republic of Macedonia
GIZ	German International Zusammenarbeit/Cooperation
ICK	Innovation Centre Kosovo
ICT	Information and Communication Technology
IFC	International Finance Corporation
KIESA	Kosovo Investment and Enterprise Support Agency
MFE	Ministry of Finance and Economy
MED	Ministry of Economic Development
STIKK	Kosovo Association of Information and Communication Technology
TAK	Tax Administration of Kosovo
VAT	Value Added Tax
WB	The World Bank

1. Background

1.1. Objectives

This position paper provides assistance to STIKK (Kosovo Association for Information and Communication Technologies) to thoroughly examine the business climate and potential benefits of tax cuts and incentives for promoting exports of ICT services. Currently, Kosovar companies are facing many barriers of doing business including the absence of any tax incentives/breaks, which could stimulate them to further increase their activity, employment and business process outsourcing (BPO). The aim of the assignment is to analyse the socio-economic impact of an eventual incentives package for the ICT sector oriented towards exports.

Tax holiday incentives are commonly used by governments in developing countries to help stimulate foreign investment. Tax Holiday is a temporary period, during which time the government removes taxes on certain items, in order to encourage the consumption or purchase of these items. The key informants interviewed for the purpose of this study uniformly agree that Kosovo currently offers a quasi Tax Holiday for exporting companies, as the only tax applicable to exported ICT services is the profit tax which, is set at 10%.

1.2. Sector at a Glance

ICT sector in Kosovo is characterized by a large number of small and medium-sized companies with limited capacities for large-scale projects and endeavours. Due to the small-size of the market, companies that grow beyond competitiveness have been forced to spin a part of their operations off into new enterprises in order to maintain market leadership. As such the local economy and sector development does not allow for large industry-scale enterprises to emerge that would be competitive both in the local market and internationally.

One of the biggest obstacles to sustainable growth of the sector has been the supply with skilled labour force, which has also conditioned the level of service sophistication that local companies can offer both locally and in international markets. Lack of academic and professional programmes equipping the labour force with high-quality knowledge and education which follows global up-to-date trends and information is one of the biggest bottlenecks for sector growth in general and increase of export of services in particular.

Despite the nature of the sector and its pioneering into innovation and development, e-commerce remains a very limited sales channel for Kosovar ICT companies. This is largely due to the limited local infrastructure for e-business, which has resulted in reduced interest of local companies to utilize this sales channel.

The current development pace has been enabled by private sector drive and innovation and has been at times hindered by structural gaps and obstacles in the business environment. While most of the businesses interviewed for the purpose of this study agree that the current tax system in Kosovo allows for significant competitiveness levels that are suitable for fostering export-oriented services, currently there are no government incentives in support of export-oriented companies.

2. ICT Service Providers' Perspective

2.1. Defining export of services (origin and place of delivery)

Low labour costs and relatively skilled labour in some sub-segments, have been the primary drivers of continuous growth of export of services among the ICT companies in Kosovo. The availability of sales channels and availability of skilled labour have conditioned the business process outsourcing (BPO) to be the best model for exporting software development services, telemarketing, mobile application development, and multimedia production.

All registered businesses in Kosovo are subject to: (i) flat income tax of 10% and a VAT of 16%. These tax norms are uniform and do include also rendered services. Similarly to export of goods, export of services is also subject to Exclusion from VAT[1], while currently there **are no additional incentives for export oriented** service companies. The **origin and place of delivery** are the two key determinants for Kosovo Tax Administration and Kosovo's corporate tax system related to the rendered services and exported products benefiting from the exports VAT Exemption as per Law 03/L-146 – On Value Added Tax (i.e. software's, telemarketing activities, etc).

2.2. Exporting sub-sectors

The sub-sectors linked to the ICT industry in Kosovo, which are deemed to have potential for export and niche market opportunities abroad, are mainly focused on these key areas:

- Software development / programming / coding;
- Engineering services / network and system operations/management;
- Business Process Outsourcing (BPO);
- Mobile applications development;
- Graphics / Post production enhancement (Media);
- Telemarketing and Support Centres (Call Centres).

The IT Barometer[2] survey recently completed by GIZ notes that in the last few years, the percentage of exports as compared to total sales has increased significantly. In the period 2012 – 2014 the companies included in the survey reported exports' accounting between 21% and 32% of total sales. The report also foresights a continuous increase during 2014 that will lead to exports accounting for up to 44% of total sales. The primary export markets for Kosovo ICT service companies include Western Europe, with a particular focus on German Speaking Countries (DACH), which account for 29% of total ICT services exported in 2013.

2.3. Barriers and Main Challenges for the sector

The ICT service exports have demonstrated substantial potential for additional growth and employment generation, albeit they serve primarily domestic customers. The current rate of estimated ratio of exports as total sale of the ICT service sector in Kosovo is 10% of total revenues of ICT companies. The exporting companies interviewed for the purpose of this research indicate similar clusters of challenges, which primarily include:

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[1] Law 03/L-146 – On Value Added Tax. Article 20, Sections 2.1 and 2.2.
[2] IT Barometer 2014 (page 27) - http://www.stikk-ks.org/en/publications/publications/2014/

- No government incentives to foster export of services or tax easing with this regard (i.e. income tax reduction, subsidised employment, etc);
- Lack of qualified individuals enabling mass production activities (i.e. mainly export oriented services);
- Non-adapted professional qualification system/Skills mismatch – no specific professional education/certification school/institute regarding ICT certifications.

2.4. Expected Socio-Economic Impact of Tax Holiday for ICT Exports

Kosovo's Tax Administration reported EUR Mil. 305,453 collected revenues for the year 2013 from all tax categories. The corporate and income tax categories jointly represented around EUR Mil. 64,273 (21.4 % of total TAK revenues). The biggest part of TAK revenues comes from border taxes and internal trade activities with VAT revenues comprising the highest portion of TAK revenues, totalling at 48.84%. If we are to propose a deduction of income and corporate tax from 10% to 5% for all exported ICT services, and subsidize tax contribution for new hires from 10% to 5%, the following scenario could be generated:

Basic Variables

Current ratio of service exports => **33% in 2013 – and 44% in 2014 (expected)[1].** The data from various research reports indicates that while the government capital expenditures for ICT hardware's are declining the services part, with specific focus on software development and BPO's, is increasing and further expected to do so.

Total sales of ICT companies in Kosovo => EUR Mil. 60 / annum. Thus, it results that the exported services weight between 19.8 (EUR Mil 60 *.33%) to EUR Mil. 26.4 (EUR Mil. 60*.44%) / year.

ICT companies' contributions to TAK budget are estimated 1.5% of total revenues collected.

[3] Source – TAK Annual Report 2013 http://www.atk-ks.org/wp-content/uploads/2010/09/Raporti-i-punes-per-vitin-2013.pdf

Short Term

a. Corporate and income tax reduction from 10% to 5%

EUR Mil 19.8 x 5% => **0.99 EUR Mil** => less into the budget **for 2013** (only 1, 5% of the total revenues on these two categories)

EUR Mil 26.4 * 5% => **1.32 EUR Mil** => less into the budget **for 2014 (**only 2, 5% of the total revenues on these two categories)

b. Subsidized tax contributions for new employees – income source tax from 10% to 5%?

2013 Income tax – EUR Mil 61.962 x33 % (out of ICT total 1.5% => 0.495 are ICT exports of 33%) = **EUR Mil 0.204 (204,000) – reduction**.

2014 Income tax – EUR Mil 61.962 x 44 % (out of ICT total 1.5% => 0.66 are ICT exports of .44%) = **EUR Mil 0.272 (272,000) – reduction**.

Total for 2 years => **TAK is of EUR Mil. 2.786** (2.31 from CT and 0.48 from IT).

This total amount could be recovered for less than two years however these incentives could generate at least two times more income taxes (same reduced rates) with an assumption that around **500 – 700 new employees** would be hired by service export oriented ICT companies, representing a ***yearly income for TAK of around EUR Mil.1.875***

Under these assumptions, in case that **income and corporate tax exemption /incentive** and subsidised taxes for new employees are applied to ICT service exporting companies, the short term perspective as compared to the long-term outlook is presented in the two boxes both on the left and right hand side.

Medium-term

Assuming that only EUR Mil. 2.786, will be reduced from the budget for the two year period as illustrated above (2013 - 2014), the increase of exports of services would mean:

- Reduction of unemployed individuals, mainly among young;

- Assuming that the industry will create ~ 500 and 700 new jobs due to these incentives (5% reduction of CT and IT) with an average salary of EUR 400 => (~ EUR 20,000 – EUR 28,000) / monthly salaries / EUR 240,000 –EUR 336,000 / annually would contribute to Kosovo budget only through Income tax (5% rate) with around 12,000 to 16,800 **at employee level**, while the Employer (company level) with an increase of 20% (EUR Mil. 26.4/20%) this would mean around EUR Mil. 31.68 would be generated in 2015 – representing around EUR Mil 1.585 in Corporate Tax payments.

*Thus a total of around **EUR Mil. 1.875** (EUR Mil. 1.585 for CT + EUR Mil. 0.29 for IT) **would be paid in during 2015**, compensating for **1 and ½ years** the short term gap of EUR Mil. **2.786** for two years in TAK budget.*

3. Government's perspective

3.1. Contribution to the budget

The tax collection structure is pretty uniform across sectors, leaving little space for creative revenue streams. The Government budget continues to be fed primarily from taxes on trade of goods, and its collection mainly is done through customs at the border crossings. The total contribution of border collected taxes for 2013 includes EUR Mil. 837.4 from Customs Duties and EUR Mil. 149.1 from VAT on imported goods, hence accounting jointly for 65.7% of the Government annual revenues/budget for 2013 (EUR Bill. 1.5). With production and processing sectors lagging behind in development and internal revenue streams remaining weak, in the near to medium future, the situation is very unlikely to change dramatically.

3.2. Impacts from potential tax exemptions

It has been argued that tax exemptions for export oriented services would adversely impact the anyway modest Kosovo Government budget. This argument however, does not hold neither in the short term nor in the long run as evidenced in this paper. Given the increased internal collection efficiency, and greater formalization in the market, coming from the process scrutiny for companies wanting to benefit from incentives, the impact on the budget is insignificant. In the contrary, the budget will benefit from increase of tax contributions both from companies (corporate tax) and employees (income tax) as a direct consequence of increased volume and value of service exports. While the positive impact in terms of jobs generated and increased formalization will scale up progressively with the increased volume of exports, the negative short-term budget costs, become less noticeable.

The 'friendly climate' image developed with the incentives package proposed under this paper has the potential to unleash full market capacity and engage creative companies into positioning globally or regionally instead of just in the domestic market and trigger a chain reaction with numerous possibilities presented to the local ICT companies. It can also lead to a series of new export oriented ICT start-ups with vast potential for niche markets. Seed funding and support services for start-up companies should also be continued to be offered by both STIKK, and ICK and other public or non-governmental sources.

3.3. Plans and perspectives/incentives

The Ministry of Trade and Industry supported by international organizations[4] has begun developing an incentives package as part of KIESA coordinated efforts to attract Foreign Direct Investment. The political limbo following the 2014 national elections has stalled this process and currently, only isolated fiscal and non-fiscal incentives are provided. Recently some improvements were also made with regards to the legislation on Economic Zones, and incentives provided to Agro-processing industry, however there is a general agreement that the current legislation and support infrastructure (inclusive of sub-legal acts) need to be improved. Also, clearer definitions of actions from respective municipalities to create necessary preconditions for FDIs should also be made through the legal amendments.
One suggestion would therefore be to develop a specific outline of the **Tax and Employment incentives,** which is perceived as necessary for attracting Investments in the Economic Zones. They need also to include tax exemptions for export oriented services, namely, ICT related ones among others.

[4] World Bank (WB), International Finance Corporation (IFC), European Commission

4. Policy Recommendations

The Government of Kosovo should reduce the personal income tax for all new hires for at least five years in the ***ICT companies*** at 5% from the current 10% of gross earnings and should also make the same adjustment to the Corporate Tax (flat 5%).

Government budget would be affected by around EUR Mil. 4.2 in 2015, however the contribution to the economy is around 20% increase of service exports and around 500 – 700 new jobs created, with a budget contribution in taxes of around EUR Mil. 3.2 within the same year. Net loss of EUR Mil 1 could be easily recovered from other revenue sources (i.e. rents, IPR rights, etc).

Five year horizon 2015 – 2019 for the Kosovo budget would imply:

Debit = > EUR Mil. 21 € (5 x EUR Mil 4.2)
Credit = > EUR Mil. 16 (5 x EUR Mil. 3.2) – if constant turnover as in 2014 of exports of services – **Low probability**
Credit = > EUR Mil. 19.2 (5 x EUR Mil. 3.84) - with an annual 20% increase of exports of services – **High probability**

The difference is outweighed by personal income tax and corporate tax increased contributions and revenues in the medium and long term.

5. Key Intervention Points

5.1. Public Institutions: MFE / TAK & MED

Given the current ICT service light tax burden, the suggested legislative acts, namely administrative directives should be amended to allow for three types of incentives related to export oriented services in ICT:

1. CT (corporate tax) reduction to 5% from its current rate of 10% for exported ICT services;
2. IT (income tax)reduction to 5% from its current rate of 10% for ICT exported services;
3. Additional employment/job creation incentives, such as:
   a. Subsidies of at least 50% of the cost of trainings/certifications of new professional staff (entrants),
   b. Partial reimbursement (up to 50%) for one year of new employee salaries hired by ICT service companies,
   c. Partial compensation for highly skilled labour [5] engaged by ICT companies.

5.2. ICT Association

Kosovo ICT Association should proceed with taking upon the responsibilities assigned to it in the national ICT strategy, as well as, the burden of representing the collective interests of the sector. It is upon STIKK to follow up on the policy recommendations from this paper and advocate for their implementation with the relevant stakeholders.

[5] PhD formal education level or equivalent top professional certification

In addition, STIKK should also propose models for sectoral promotion internationally, and lead the way into combining sales efforts of local ICT companies to international markets. Aside from the traditional channels of promotion such as fairs and large-scale events (i.e. CEBIT), participation in smaller specialized events for sub-industries has been deemed as more effective to facilitating sales in niche markets.

5.3. Chambers of Commerce

Chambers of Commerce should utilize their networking potential and facilitate client sourcing for the ICT sector. Promotion of the sector as a whole and the unique cooperation opportunities that some Kosovar companies may represent to international counterparts should be supported more effective.

The local ICT companies have demonstrated performances in projects as per international standards, and can be a useful resource for international companies interested in outsourcing processes. International events such as fairs, conferences, workshops and other networking forums should be attended and organized by chambers of commerce in support of sectoral development within the ICT industry.

Greater involvement and presence among ICT companies should also be encouraged by the Chambers of Commerce as a tool to streamline sectoral priorities into capital planning and policy formulation processes. Active engagement of STIKK and its members in working groups and other important processes that impact the performance of the sector is encouraged.

Greater ICT sector representation in bi-partite and tripartite dialogue between social partners should also be ensured by the chambers of commerce. The specifics of jobs and professions within ICT sector and other service industries should be taken into account when drafting future labor related legislation.

6. Useful International Lessons

6.1. Estonia at a Glance

Today in Estonia, there is an estimated 1,500 ICT companies, whereas the market is rather concentrated. The eight biggest enterprises account for up to 80% of domestic market for ICT goods and services, while smaller firms carry out various sub-contracted activities and/or specialize on 'tailor made' software development [6]. ICT services are dominated by telecommunication service providers, which produced in 2006 more than 50% of total sales of the sector. Computer services branch of Estonian ICT sector that includes also software developers is, however, much more fragmented. More than 1,100 Estonian ICT companies belong to this segment, whereas less than 100 employ 10 or more persons. Often, the ICT sector of Estonia has been regarded as a subpart of the Scandinavian ICT cluster, primarily acting as subcontractor to Scandinavian companies. "Empirical evidence shows that the Estonian ICT manufacturing sector is actually part of the larger Nordic ICT manufacturing cluster. The main branches of the Estonian ICT manufacturing industry are exactly the same as those of Finland and Sweden."[7]

The importance of ICT sector to Estonian economy has had a constant increase since the beginning of 1990s. Estonia is one of the countries that has most advanced e-government infrastructure in the world and includes a broad range of ICT application in public service delivery. The country has one of the most developed ID card infrastructure that enables numerous possibilities for ICT service industries. Despite its small size in terms of global ICT market, the Estonian ICT sector is very well-developed in some segments.

Some of the peculiar approaches to ICT industry development in Estonia include:

- Cluster-based strategic planning approach has been utilized to differentiate between different ICT sub-segments and also strengthening the weakest links in the cluster;
- The skills mismatch in the labour market was addressed via well-designed education and training policies;
- Enabled PPPs for improving higher education in IT that supports capacity development and triggered further competitiveness of the sector;
- Regional cooperation (Baltic Sea) was utilized for establishing 'Virtual University' type of schemes.

The three main policy/action fields important for the success of Estonian ICT industry include:

1. Development of citizen-centered and inclusive society;
2. Development of knowledge-based economy;
3. Development of citizen-centered, transparent and efficient public administration.

[6] ICT Sector in Estonia – Foresight Study: http://www.ibs.ee/publication/BEFORE%20ICT%20Foresight.pdf

[7] Estonia Country Report: EU IST Community.net

6.2. FYROM's Support to High-Value ICT Services

Macedonia's Government initiatives and decisions to promoting investments in their country and attracting FDI, were quite substantial and have been supported with important resources and tools. Government has established four Free Trade Industrial Zones in country's main economic and administrative centers.

The following tax incentives[8] are part of the overall investment incentives offered by the FYROM, which also include the ICT sector and services in general:

Tax incentives

- Zero tax rate (Corporate, VAT, Excise) for operation in the Technological Industrial Development Zones;
- 5% VAT on computers, computer parts, and software;
- Zero percent operation tax if invested on a Free Economic Zone.

Employment incentives

- 50 % reduction of Personal Income Tax for 5 years for operation in the Technological Industrial Development Zones;
- 1/4 of social contributions cut as of 2012.

These measures have been praised by both current and potential investors as well as international institutions (i.e. WB and the IFC) as to brining a favourable investment and enabling environment in the country.

The incentives packages for investors and tax cuts combined with improved public administration efficiency and increased utilization of ICT in rendering services to citizens have been some of the most important aspects of the reforms made by the Government of FYROM in attracting direct investments from abroad.

With particular relevance for the ICT sector have been the subsidies provided by the government for employment of highly skilled/highly specialized labour that enable ICT companies to offer high-value services and orient their activity towards exports.

[8] Source – ICT Sector in Republic of Macedonia & http://www.macedoniaindia.com/pdf/Invest%20in%20ICT.pdf

6.3. Bulgaria's International Success

The economic and fiscal reforms of Bulgaria as part of its EU Accession process and particularly the reforms undertaken as part of the Investment Promotion Act (IPA) have enabled the country to attract significant amounts of FDI across a broad range of sectors. ICT sector has been one of the biggest beneficiaries of these reforms, which also reflected in real terms through their performance. Software development companies in Bulgaria in 2010[9] exported 50% (mainly to EU and US) of the total outputs for the sector in the country. In addition, IT outsourcing services have been increasing at a 25% rate in recent years, making Bulgaria[10] one of the most attractive locations in CEE.

Some of the key tax and employment incentives[11] for Service and Manufacturing companies in Bulgaria that are believed to rest behind the international success of the Bulgarian ICT sector include:

Tax incentives

- VAT fully exempted for import of equipment for investment purposes of a minimum EUR 5 million and employment of 50 workers;
- Possibility for R&D expenditure write-off;
- Accelerated depreciation of 2 years for computers and new manufacturing equipment;
- 5% withholding tax on dividends and liquidation quotas (0% for EU tax residents);
- No restrictions concerning capital repatriation.

Employment incentives

- Full reimbursement of up to 1 year minimum salary and reimbursement of social security and healthcare for employing registered unemployed in several specific categories (i.e. young and elderly unemployed individuals, single mothers with children, unemployed with reduced mobility, etc);
- Coverage up to 50% of the employee training costs.

[9] http://www.investbg.government.bg/en/sectors/facts-18.html

[10] http://www.investbg.government.bg/en/news/afp-it-outsourcing-boom-boosts-struggling-bulgaria-872.html

[11] Source – Invest Bulgaria Agency

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